

Eliminating Barriers to International Trade and Investment in Services

by James R. Basche

Management Summary

- Trade barriers to services exports more than ever are of critical concern to both U.S. and foreign services companies, a recent Conference Board survey finds.
- However, barriers to international investment in services are emerging as an equally important concern, the survey finds.
- The important role played by investment in the international services market is a factor to be considered in any future round of multilateral trade negotiations.
- There are two directions that executives in the services sector would like their own government negotiators to take in addressing the concerns of services industries with regard to barriers to services trade and investment: to become more knowledgeable about the importance of worldwide and national services trade and investment and the concerns of each of the particular services industries; and/or to permit participation in future negotiations by industry representatives.
- Strongest support is given to using existing, general, multilateral approaches for tackling international trade issues in the services sector; but considerable support is given to using new, industry-specific bilateral approaches as well.

Economic and Policy Analysis Program

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Issues and Highlights

Services industries involved in international business have been demanding and receiving increasing attention in recent years from both government and business leaders and organizations. Since a GATT (the General Agreement on Tariffs and Trade, see adjacent box) ministerial meeting in November 1982, the United States has strongly urged that trade and investment issues of the services industries be included in any new multilateral negotiations. After much lobbying by the United States and other nations actively engaged in the international services industries, GATT decided at the Punta del Este meeting in Uruguay in September 1986, to include those areas in its next round of negotiations.

The Conference Board has several hundreds of Associate companies active in the services sector. Informal discussions with executives of some of them late in 1985 and early in 1986 indicated differences in views about using the GATT organization to eliminate barriers to their international operations. Therefore, in the Spring of 1986, The Conference Board undertook a survey of 525 associate firms around the world that are active in a variety of services industries. The purpose of the survey was to ascertain the views of business leaders in services firms involved in international business on the use of GATT or some other approach to eliminate international trade and investment barriers in the service sector. Usable responses were received through July 1986. (See Table 1.)

- A total of 525 survey letters were sent. In all, 141 responses (27 percent) were received from 23 countries. Of these firms, 115 had international services operations.

- U.S. firms made up slightly more than half of all the respondents largely because of the preponderant number of U.S. services firms in The Conference Board's Associate list to which the survey was sent.

- A significantly higher proportion of European services firms receiving the survey (51 percent) sent in responses than was the case with other parts of the world.

The distribution of responses by different types of services industries is shown in Table 2.

- The 141 firms responding had 227 distinct international operations.

- Of these, nearly half were in financial services.

- Professional services make up about 10 percent and transportation and shipping services and business services about 8 percent each of all the operations.

- Except for the preponderance of financial services, the survey responses come from a wide variety of international services.

Overview of Trade and Investment in Services

The economic significance of the services sector both domestically and internationally has grown steadily in the past two decades. In many developed and some developing countries employment in the services sector has reached substantially more than half of total employment. (See Table 3.) Services as part of gross domestic product (GDP) have also

What Is GATT?

The General Agreement on Tariffs and Trade (GATT) was negotiated in 1947 under the auspices of the UN Economic and Social Council, and entered into effect as a separate agreement on January 1, 1948. GATT was meant to be an interim agreement among the contracting parties to permit them to resolve certain trade issues of that time. A more permanent specialized agency attached to the United Nations, the International Trade Organization (ITO), was proposed to become the instrument governing international trade and promoting liberalization of that trade for its members. Although the ITO was negotiated, it was never ratified. This left the interim GATT as the only agreement, and its secretariat as the only capable organization, establishing rules for international trade and supported by most of the major trading nations in the world.

Thus, GATT has emerged both as a set of rules and principles and as a forum for negotiating changes to them or for developing new ones. Its secretariat also provides a framework and machinery for settling trade disputes that arise among the 92 contracting parties. Its main purpose is to foster the liberalization of international free and fair trade in a manner mutually acceptable to its contracting parties and protective of their individual interests in matters of special and temporary concern.

Since its founding GATT has held seven "rounds" of multilateral trade negotiations: Geneva (1947), Annecy (1949), Torquay (1951), Geneva (1956), Geneva—the "Dillon Round" (1959-62), Geneva—the "Kennedy Round" (1963-67), and Geneva—the "Tokyo Round" (1973-79). The first six rounds were mainly concerned with the reduction of tariffs. The seventh, however, was expanded to include negotiations on the elimination of nontariff barriers as well. Codes were developed on such subjects as subsidies and countervailing duties, antidumping measures, import licensing procedures, and government procurement practices. The talks in the Fall of 1986 are preliminary to a proposed new round of multilateral trade negotiations.

Because GATT was originally meant to be an interim organization its structure is limited. Its highest body is the Session of Contracting Parties, a meeting of trade ministers usually held once a year. Between these meetings, a Council of Representatives to GATT meets more frequently to deal with both routine matters and any urgent business that may occur. GATT has a paid staff of about 300, is headed by a Director-General, and is headquartered in Geneva, Switzerland.

shown important growth in the last 20 years. Both developed and developing countries are included in this growth, although the level of services in the developing countries lags behind that in the developed countries because it started from a lower base 20 years ago. (See Table 4.) Internationally, trade in services (excluding returns from foreign investment) had reached more than 20 percent of merchandise trade by 1980 and has continued to move up.¹

In the debate on barriers facing firms with international

¹ U.S. National Study on Trade in Services: A Submission By the United States Government to the General Agreement on Tariffs and Trade, 1984. Washington: U.S. Government Printing Office 1984. Other national studies for selected countries available from GATT in Geneva.

Table 1: Geographical Distribution of Survey Responses

Area	Survey letters sent		Survey Responses		Response Rate
	Number	%	Number	%	
United States	366	70	74	53	21
Canada	61	12	20	14	33
Europe	72	14	37 ^a	26	51
Other	26	5	10 ^b	7	39
Total	525	100 ^c	141	100	27

^a Includes Austria, Belgium, Denmark, Federal Republic of Germany, France, Italy, Liechtenstein, Netherlands, Norway, Sweden, Switzerland, United Kingdom

^b Includes Brazil, Colombia, Indonesia, Japan, Mexico, Philippines, South Africa, Thailand, Trinidad and Tobago.

^c Details do not add to 100 percent because of rounding.

operations attention has been focused upon *trade* in services. However, international *investment* in the services sector also faces barriers. This report, therefore, also highlights the role of international services investment in the overall debate on problems facing international services. Examples of investment by a service firm overseas include the establishment of a branch bank in Brazil by a foreign banking firm, the construction of a hotel in a resort area by an international hotel chain or tourist organization, the organization of a joint venture accounting firm between an American firm and a local firm to serve local clients in Thailand, and the setting up of a fast-food facility by a foreign-owned restaurant chain.

International investment in the services sector is an important part of total world investment across national borders. The International Trade Administration of the U.S. Department of Commerce, for example, reported that of 362 identified cases of foreign direct investment in the United States in the first three quarters of 1985, 156 (43 percent) were in the services sector.² These investments came from 24 countries in Europe, Asia, South America, the Caribbean area and the Middle East and were classified in 27 different service-industry categories.

International Services—Trade, Investment or Both?

Most of the companies responding to The Conference Board's survey operate internationally in one or more of the service sectors in which they operate domestically.

Many responding firms are active in more than one sector of services industries. A U.S. company, for example, reports operations in the entertainment field and in non-bank financial services; a European firm works in ocean freight shipping and in tourism; another European firm provides security services, EDP services, and waste disposal services; a South American company has both banking and travel services; and

a Canadian company has trucking subsidiaries and also provides oil field services.

The diversity of business operations combined under the rubric of "services industries" involves a large and diverse number of national and other governmental regulations that create the barriers to international trade and investment in those countries for the regulated industries. The diversity of industries in which international services businesses are involved precludes the easy possibility of services industries organizing a united front on what needs to be done to eliminate the barriers and how best to do it.

Of the total of 141 firms replying, 115 (82 percent) have some international business operations. Among the 24 companies (17 percent) that have no international business, one sector stands out. Eight of the nine utilities companies participating in the survey report they operate entirely within their home countries. They are mainly local gas and electric utilities in the United States, but include one firm each in Canada and in Europe. Of the seven retail firms participating in the survey, three have no international business. The sectors from which the other firms without international business come are financial services, telecommunications, oil-field services, publishing, and education and training services.

International business, whether in goods or services, can usually be undertaken by exporting the product from the country where it is produced (trading) or by establishing facilities outside the firm's home country (investing) from which its products are sold in the country where the facilities are set up, back to the home country, or to third countries. Obstacles to international business operations, therefore, can be in the form of barriers to trade or barriers to investing.

Because the services sector requires that many of its intangible products be consumed at the place of production, the need to establish the company's facilities at the place—making an investment—is especially important to that sector. The United Nations Centre on Transnational Corporations has made a preliminary study of the importance of foreign direct investment (FDI) to international business in the services sector. The study found that investment is more important than

² U.S. Department of Commerce, International Trade Administration, "Quarterly Report on Foreign Direct Investment Activity in the United States" for first 3 quarters of 1985. (Available as printouts from the ITA in Washington.)

Table 2: Distribution of Responses by Services Sector (141 Firms with 227 Operations)

Financial Services—total		105
Banking	53	
Non-bank financial services	27	
Insurance	25	
Professional Services - total		22
Engineering	12	
Management consulting	5	
Accounting	4	
Public relations	1	
Transportation and shipping - total		19
Air	7	
Ocean	5	
Truck	2	
Rail	2	
Freight forwarding	2	
Port services	1	
Business Services - total		19
EDP	7	
Leasing	4	
Maintenance (equipment)	3	
Security	2	
Advertising	1	
Manpower	1	
Development of business centers	1	
Telecommunications - total		10
Utilities - total		9
Retail firms - total		7
Tourism - total		7
Other - total		29
Publishing	4	
Education & training	3	
Information services	3	
Entertainment	3	
Franchising	3	
Real estate development	3	
Oil field services	2	
Waste disposal management	2	
Construction	2	
Food Catering	1	
Health Care	1	
Energy Services	1	
Laundry and cleaning services	1	
Total		227

trade and attributed this fact to the intangible nature of many services as compared to tangible manufactured products and natural resource commodities.¹

The importance of both investing and trading in international services is clearly shown by the responses received to its survey by The Conference Board. Slightly more companies report their international operations are more investing

¹ Karl P. Sauvart and Zbigniew Zimny, "FDI and TNCs in services," *The CTC Reporter*, No. 20, Autumn 1985, p. 24.

Table 3: Percent of Total Employment in Services for Selected Countries, 1975 and 1984

<i>Developed</i>	1975	1984
Belgium	66	74 ¹
Canada	72	75
Japan	61	66
Sweden	65	72
United Kingdom	65	72
United States	72	76
<i>Developing</i>		
Brazil	47 ²	54 ³
Republic of Korea	35	48
¹ 1983		
² 1976		
³ 1982		

Source: International Labor Organization, *Yearbook of Labor Statistics* 1985

than trading, and more than one-third say their operations are both. (See Table 5.)

If the question is considered by individual services, the investment edge is more pronounced with almost two-thirds of the operations relying mainly on investing or both investing and trading while almost three-fifths are involved in trading or trading and investing.

The importance of international investment is even more clearly seen in a number of specific industries.

— 90 percent of the responding firms in business services are involved in foreign investments;

— 86 percent of the tourism operators are similarly involved;

— three-quarters of the insurance and non-bank financial services firms operate through investments or investments and trade combined.

Only firms in professional services and the transportation and shipping industries give more importance to trading their services than to investing abroad to provide those services. (See Table 6.)

The conclusion emerges from the survey that given the fact that sometimes more services firms with international operations are involved in investment as against trade, there is a need for future multilateral trade negotiations to consider investment barriers as well as trading barriers if obstacles to doing business in foreign markets are to be eliminated for the services industries.

Of the 81 responding firms that listed investing alone or both investing and trading as their way of doing business in foreign markets, 65 give their reasons for choosing investing over trading. Only fourteen cite trade barriers. Of the fourteen, nine are banks, four are insurance companies, and one is a leasing firm. Existing trade barriers are, thus, not a major reason, according to survey participants, for choosing investing as the way to do business for services companies. General barriers applicable to all foreign companies doing business in the country and restrictive regulations on the particular industries mentioned are the usual obstacles reported.

Table 4: GDP Distribution (in Percent) for Selected Countries, 1965 and 1984¹

Country	Agriculture		Industry		Services	
	1965	1984	1965	1984	1965	1984
<i>Developed</i>						
Belgium	5	3	41	34	53	64
Canada	5	3	34	24	61	72
Japan	9	3	43	41	48	56
Sweden	6	3	40	31	53	66
United Kingdom	3	2	41	36	56	62
United States	3	2	38	32	59	66
<i>Developing</i>						
Argentina	17	12	42	39	42	50
Brazil	19	13	33	35	48	52
India	47	35	22	27	31	38
Republic of Korea	38	14	25	40	37	47

¹ Details may not add up to 100 percent due to rounding.

Source: *World Development Report 1986*. New York: Published for The World Bank by the Oxford University Press, 1986.

Economic Factors Underlying Investment

Economic factors are more important than the existence of trade barriers in the determination of which path to take—trading, investing or both—in doing business successfully in foreign markets. Among the firms in this survey giving reasons for operating abroad primarily through investments, the ratio of economic factors to existing trade barriers as the primary determinant is almost four to one.

The economic factor most frequently cited is the belief that investing is the most profitable way for the company to sell its service products. Mentioned almost as frequently is the need of most services firms to be close to their customers. This need is especially acute for those firms that sell a service consumed at the point of sale, but is also important to others who believe that being physically close to their customers, either foreign or domestic, is necessary to serve better the customers' product requirements. The managing partner of an international accounting firm sums up this view: "Effective client relations are critical to the success of professional service firms in any market. They require physical proximity, and intimate knowledge of the language, business practices and laws and regulations of the country, and a comprehension of national aspirations." These requirements for successful business, he believes, exist whether or not trading barriers are present.

Other reasons given for operating through investment rather than trading include:

- Location in a foreign market is the best way to provide after sales services and support.
- On site presence makes it easier to understand local markets and their changes.
- International legal and technical communications problems that may exist between the home country and the foreign market are more easily overcome by locating in the foreign country.
- Being physically in the foreign market gives a sense of

permanence to the operations of a foreign company, making it seem to be a part of the local community.

Still other factors for deciding to operate through investments are applicable to particular industries. Tourism companies that operate resorts and hotels in foreign markets, for example, often find that investment in those properties is essential if they are to maintain the standards associated with the services they sell around the world. Several banks with worldwide operations report that their success in providing a wide range of financial services requires that they have a presence in all the major financial centers in the world. As the number of these centers grow, so, too, the banks must expand their investments in foreign operations. As one European banker states: "The growth of international money and capital markets, and in particular the spectacular expansion of Eurocurrency markets, made physical presence in the major financial centers a prerequisite if banks are to play a significant role in international financial intermediation."

The important role played by investment in the international services market is a factor to be considered in any future round of multilateral negotiations. GATT is concerned mainly with barriers to *trade* and not with barriers to *investment*. This limi-

Table 5: International Services Operations—Trading or Investing? (in Percent by Area)¹

Area	Trading	Investing	Both	N.A.
U.S.A.	19	24	28	28
Europe	11	19	59	11
Canada	35	15	20	30
Other	20	20	40	20
Total	19	21	36	23

¹ Details may not add up to 100 percent because of rounding.

**Table 6: International Services Operations—Trading or Investing?
(in Percent by Industry)¹**

<i>Industry</i>	<i>Trading</i>	<i>Investing</i>	<i>Both</i>	<i>N.A.</i>
Financial Services-Total	13	20	50	16
Banking	21	13	51	15
Non-bank financial services	7	26	52	15
Insurance	4	28	48	20
Professional services	45	32	18	5
Transportation & Shipping	37	0	63	0
Business services	5	53	37	5
Telecommunications	20	30	20	30
Utilities	11	0	0	89
Retail stores	29	29	14	29
Tourism	14	0	86	0
Other	17	31	34	17
Total	19	23	42	16

¹ Details may not add up to 100 percent because of rounding

tation on GATT's activities applies to investments in goods production as well as to services. As indicated earlier the United States and several other developed countries have proposed and won support for the inclusion in any new round of multilateral trade negotiations of discussions on ways to remove the barriers to investment as well as to trade.

Barriers to International Services Trade and Investment

Since the launching of GATT in 1948, successful efforts have been made to eliminate many of the tariff and nontariff barriers to trade in goods. But the GATT arrangement is not universal in membership and has many loopholes. Much of the world's trade in goods still lies outside the regulations and codes developed by GATT. More significantly for a world in which the services sector is becoming increasingly important to many countries, GATT so far has excluded from its deliberations the services sector and international investment.

Because services are not yet included in the GATT system, companies in the services sector have not benefited from these efforts. A sample of the kinds of barriers still faced by services industries is given in the box on p. 8.

The outright denial of market access or the restriction on the number of foreign firms in a particular industry, as reported by banking, insurance and professional services firms, are important investment barriers. Government procurement policies that favor local companies, restrictions on advertising, and discriminatory taxation of foreign services are obstacles to trade. Some of the reported barriers (e.g., limitations on remittances abroad) apply to trade and investment in goods as well as services. The wide variety of barriers—more barriers to investment in the case of banking, more barriers to trade in the case of entertainment—and the many countries in which they occur underline the difficulties that must be faced in any international negotiations to eliminate those barriers.

In a report prepared by the U.S. Trade Representative for the U.S. Congress in 1985, 34 countries were reviewed on the subject of international trade barriers. Of the total, 28 countries were found to have some type of barriers against trade in one or more services industries. The industries most affected were telecommunications, motion pictures, insurance, other financial services (including banking), and information services. But a wide range of services industries including trucking, retail stores, professional services, and business services were reported to face some kind of obstacles and discrimination.⁴

A survey of recent government reports and other literature on the services industries reconfirms the following important points about doing business in this sector:

- The growing economic significance domestically and internationally of the services sector especially for the developed countries and especially as a source of jobs.

- A large number of barriers exist to international trade in services that currently are not subject to any international agreement to regulate or reduce such obstacles.

- Trade in international services generates barriers that may differ from and be in addition to the kinds of barriers facing international trade in goods because many services industries require that the service sold be produced at the point of use—unlike trade in goods that permits production in one place and use in another.

- National governments disagree on the appropriate organization as well as the appropriate approach to be used to eliminate these obstacles.

To these results of recent studies and meetings on interna-

⁴ Office of the United States Trade Representative, *Annual Report on National Trade Estimates 1985* (as required by Section 303 of the Trade and Tariff Act of 1984) submitted by the U.S. Trade Representative to the Congress of the United States.

Barriers to International Trade and Investment in Selected Services Industries.

Banking:

- Prohibition on entry of foreign banks.
- Restricted number of foreign banks allowed in country.
- Restrictions on number of branches allowed each foreign bank.
- Foreign banks restricted geographically on where they can locate within a country.
- Local equity requirements imposed on foreign banks.
- Restrictions on retail banking operations by foreign banks.
- Restrictions on data processing and transfers.
- Restrictions on operations by foreign banks (e.g. lending ceilings for loans in both foreign and local currencies; no access to rediscount facilities).
- Denial of the national treatment principle generally.

Insurance:

- Outright denial of market access to foreign companies.
- Restricted number of foreign companies allowed in country.
- Equity limits for foreign ownership.
- Prohibition of the sale by foreign companies of certain kinds of insurance (e.g. marine insurance on imports, fire insurance, life insurance).
- Foreign companies allowed to insure only their own citizens or companies owned by their citizens.
- National government monopolies control certain kinds of insurance (e.g. reinsurance) and forbid participation by foreign companies.
- Governments require foreign companies to establish local subsidiaries and not export insurance services from home countries.
- Restrictions on advertising by foreign insurance companies.
- Discriminatory taxation against foreign companies.

Professional Services:

- Outright prohibition against foreign citizens working in some or all professions.
- Discriminatory professional certification rules and procedures.
- Difficulties in obtaining work visas and permits.
- Restrictions on the transfer of professional publications, training materials and software.
- Restrictions on international electronic data transfers.

- Inadequate protection of intellectual property.
- Government procurement policies for services that emphasize "Buy National."
- Restrictions on international payments and remittances.
- Government export subsidies in the engineering/architectural/construction industries.

Telecommunication and Informatics:

- Restrictions on international electronic data transmission.
- Market quotas set for foreign equipment or outright prohibition of its use.
- Standards set up to exclude foreign equipment.
- Discriminating taxes and tariffs to favor local firms.
- Requirements that all firms process data locally.
- Restrictions on the provision of enhanced services by foreign companies.
- Government procurement favors local companies.

Entertainment:

- Screen time quotas for local and foreign theatrical and TV films.
- Foreign films must share theatre bills with local films.
- A fixed percentage of the box office receipts must go to the local films.
- Royalties are set by local committees.
- Film prints must be locally made.
- Dubbing of foreign films must be done locally.
- Import quotas are used for numbers of foreign theatrical and TV films.
- Discriminatory taxation against foreign films.
- Foreign companies not allowed to set up own film distribution offices.
- Foreign companies pay high fees to local film organizations that control import licenses.
- Government subsidies to local film producers.
- Government requires foreign film companies to underwrite local film industry through subsidies and interest-free loans.
- Restrictions on currency remittances.
- Pirating of foreign films.

Sources: The Conference Board's survey responses; Office of The United States Trade Representative, *Annual Report on National Trade Estimates 1985*.

tional services trade, this Conference Board report adds another:

— *The services industries themselves do not agree on the appropriate approach and organization to best resolve the issues of concern to them in conducting their international business.*

Indeed, there is no "services sector viewpoint" on most issues involved in international services trade and investment. Viewpoints may vary by industry and, sometimes, by firms within the same industry. Among the retail firms participating in The Conference Board's survey, for example, three are U.S. companies in the retail food business. Two of the firms believe steps should be taken to eliminate barriers to their business outside the United States, while the third says international barriers have "not been a problem and the current environment is fine."

Comments on specific barriers also reveal substantive differences of view among services industries and individual firms. Several survey respondents point out that because the service often has to be produced on the spot where it is used, professional and skilled workers who provide the service must be able to move across national borders to the site where the service is to be provided. Many countries, however, have restrictions on the movement and employment of foreign labor at all levels of skill. This is an important barrier to competition abroad in their business, according to several services executives, and must be included in any negotiations at GATT or elsewhere to eliminate trade barriers. Among the respondents to this survey calling for such inclusion are a U.S. accounting firm, a large U.S. bank, a European retail company, and a Canadian company that provides engineering services to the petroleum industry.

In contrast to the last, a U.S. engineering and construction company recognizes the issue but does not believe it should become part of new multilateral negotiations on international trade issues. This view was supported by the International Engineering and Construction Industries Council (IECIC) in a statement issued on March 20, 1986.

The disagreements among services firms on the issues and problems extend to where the negotiations should be undertaken to eliminate barriers to the services trade. Of the 141 services companies and conglomerates with services units that responded to The Conference Board's survey, 57 (40 percent) report they favor working through an expanded existing multilateral general trade organization, such as GATT, as the best means to eliminate international barriers to trade and investment in their own industry and for their own firms. Almost as large a number (48 firms, 34 percent) favor using bilateral agreements covering a single or related group of services industries as the best means for their industries to remove trade and investment obstacles. Several give equal emphasis to both approaches—the general multilateral and the industry-specific bilateral.

The responses cover a wide range of views. At one end is a Canadian banker who writes, "There are no significant barriers to trade in our fields," and concludes, therefore, that none of the alternative approaches to eliminating trade and investment barriers is needed. A U.S. insurance executive, in contrast, calls for using all available alternatives and writes: "Introduction of services in the GATT is clearly important. I would not mind seeing a new multilateral organization to develop general principles on international trade and investment for the services industries. An industry-specific multilateral organization dealing with barriers unique to a named service industry, i.e. insurance, could be useful. Bilateral agreements covering all services or a single or related group of services could also be useful."

Alternative Approaches to Eliminating Barriers to Trade and Investment in Services

Initial efforts to develop rules and guidelines for the elimination of barriers to international trade and investment in services have begun within the GATT framework for multilateral trade negotiations. Proposals to include these matters on the agenda for the next round of GATT negotiations have been made by the United States and have won support from a majority of GATT's members. Yet, an important minority group of GATT members, led by Brazil and India, has opposed the expansion of GATT's authority into these nontraditional areas at this time. They believe GATT should limit itself to its original sphere of interest—trade in goods—at least until the barriers in that area have been eliminated and GATT has given more attention to the concerns of the interests of the developing nations which, they assert, have been neglected. A compromise of these two views was reached at the GATT meeting in the Fall of 1986, to allow services and investment to be considered in future GATT negotiations.

GATT is by no means the only governmental agreement

governing international trade. There are a large number of binational, regional and sectoral arrangements applicable to trade in goods for particular geographical areas or for particular industrial sectors. Some of these have been made within the GATT framework, but others lie totally outside the terms of GATT.

Possible Approaches

As efforts are undertaken to bring some kind of order and to eliminate the obstacles to international trade in services alternative approaches to those goals are available. The Conference Board's survey asked the respondents to choose among five alternative approaches to eliminating obstacles to trade and investment for their own industries and firms:

- (1) to work through an *expanded, existing multilateral trade organization*, such as GATT;
- (2) to create a *new multilateral organization* to develop general principles on international trade and investment for the services industries exclusively;
- (3) to establish *several multilateral organizations* each dealing with a single or related group of services industries, such as insurance, tourism or telecommunications;
- (4) to negotiate *bilateral agreements* on a country-by-country basis on general trade and investment principles covering *all services industries*;
- (5) to negotiate *bilateral agreements* covering a single or related group of service industries.

Although the first and last alternatives received the greatest support from survey participants, the replies are widely distributed among all five approaches. Summaries of the responses by geographic area and industry sector are in Tables 7 and 8.

— Working through an existing general multilateral organization received the most support from companies when considered by area with European firms leading the support.

— Likewise, this approach received the most support when responses were classified by industry with especially strong support given by companies in the business services.

— Establishing a new general multilateral organization received the least support.

— An industry-specific bilateral approach had the second strongest support led by companies in the transportation and shipping field.

A few respondents suggested approaches totally outside the scope of these five alternatives. Bankers in the United States and Europe, a European insurance executive, and a U.S. publishing executive all proposed keeping governments entirely out of negotiations to end trade barriers in the services. Let private representatives of the sectors undertake the negotiations, they suggest, and bring governments in at the appropriate time after agreements are worked out by the private-sector representatives. While such an approach may be appealing to some business leaders, it is seriously unrealistic in one important aspect: Most obstacles to international trade in services (e.g., restrictions on establishment, discriminatory taxation against foreign businesses and other discriminatory regula-

Table 7: Negotiating Alternatives to Eliminating Barriers to International Services Trade and Investment (in Percent by Area)¹

Area	Alternative Approaches ²				
	Existing General Multilateral	Industry-Specific Bilateral	Industry-Specific Multilateral	General Bilateral	New General Multilateral
U.S.A.	31	30	19	18	11
Europe	65	32	14	0	5
Canada	35	45	0	10	10
Other	30	50	20	0	10
All Areas	40	34	15	11	9

¹ Total may equal more than 100 percent because of multiple responses.

² See text for more specific description.

Table 8: Negotiating Alternatives to Eliminating Barriers to International Services Trade and Investment (in Percent by Industry)¹

Industry	Alternative Approaches ²				
	Existing General Multilateral	Industry-Specific Bilateral	Industry-Specific Multilateral	General Bilateral	New General Multilateral
Financial Services - total	51	32	11	10	7
Banking	55	36	9	4	2
Non-bank financial services	56	30	7	15	7
Insurance	40	28	20	16	16
Professional services	55	27	14	18	14
Transportation and shipping	58	68	37	16	16
Business services	79	37	5	26	26
Telecommunications	70	20	0	10	10
Utilities	11	0	0	0	11
Retail stores	29	14	14	0	14
Tourism	57	57	43	29	14
Other	31	55	21	14	7
All Industries	51	37	15	13	11

¹ Total may equal more than 100 percent because of multiple responses.

² See text for more specific description.

tions, limitations on the movement of persons) are the result of government laws and regulations. Removal of these obstacles requires action by governments.

A United States insurance executive also denies the usefulness of any of the five suggested alternative approaches and argues instead for no changes to be made in the current environment for doing business internationally in the services sector. The laws and regulations affecting his industry, he points out, differ in every country, but his firm has adjusted to them and has learned to live with them. At this time he does

not want to be faced with new internationally-negotiated regulations that would disturb the current equilibrium that his firm has achieved in its international operations.

Most of the remaining participants in the survey indicate a choice of one of the five approaches as the best from the point of view of their firm and industry. For more than one-quarter of the respondents, however, two or more of the suggested approaches are equally important and they urge simultaneous efforts on those plural approaches. The stated advantages expected of general-specific, multilateral-bilateral,

and existing or new approaches are summarized in the box on p. 12.

A New Multilateral Organization for Services

Setting up a new multilateral organization to deal exclusively with international trade and investment in services draws the least support among the survey's participants. Those arguing in favor of this approach believe that existing trade organizations are not set up to handle the problems of emerging and expanding services industries, such as informatics and international health care. These services were minor players in international trade, if they existed at all, at the time existing multilateral organizations for international business were established, and services industries are distinct enough from goods industries that the two should stand separately. A Latin American executive adds, in support of a new organization, that existing organizations are too heavily directed toward the problem of the developed countries, while the needs of the less developed countries are given short shrift. A new organization would, in his opinion, remedy these handicaps.

Several respondents opposed to this approach also explain their attitudes. Most frequently mentioned is the belief that a new organization with its new bureaucracy will cost too much for the small benefits that may be achieved. Others point out that trade involving goods and services is not distinct; in fact, many believe the two are becoming increasingly intertwined. An effort to deal separately with trade issues in the two sectors will lead to confusion and inefficiency. Finally, the opponents argue that a new organization will take too long to achieve any successes in eliminating obstacles to trade now and that the uncertainty about the usefulness of a new organization will weaken its effectiveness.

General Bilateral Agreements Covering all Services

Bilateral agreements on general trade and investment principles for all services industries generate slightly more support among participants than a new multilateral organization. The support for this approach, however, comes only from North America. None of the participants outside the United States and Canada indicates any interest in using bilateral agreements on general trade principles to remove obstacles to the services industries. The North American interest can be and, by some firms, is specifically attributed to the bilateral trade negotiations begun in May 1986 between the United States and Canada. These negotiations cover many issues affecting both the services and the goods industries.

Several reasons are given by supporters of this bilateral approach:

- It permits consideration of the difference in strength of the services industry sectors on a country-by-country basis.
- It allows a services trading country to focus its negotiations on countries of greatest interest to the services industries that it wants to promote abroad.
- Bilateral negotiations are easier and more manageable than multilateral negotiations. Further, they are usually concluded more quickly than multilateral negotiations.

— By including all services sectors in one agreement trade-offs among them can contribute to the success of the negotiations—a flexibility not available when the negotiations are concerned with a single industry or one related group of industries.

— Negotiations on a country-by-country basis allow easier and more complete consideration to be given to cultural differences. These differences are often so many and so complex that they tend to be overlooked or shunted aside in multilateral negotiations.

— Several respondents believe that the successful negotiation of general bilateral agreements can set a useful precedent for future multilateral negotiations at GATT or elsewhere.

One respondent suggests that instead of initiating new general bilateral negotiations a more traditional approach should be used. FCN (friendship, commerce and navigation) treaties should be strengthened. These agreements, which have a long and honorable history in international relations, are usually signed soon after two countries formally recognize each other's existence. FCN treaties cover trade, consular, immigration and many other matters that affect commercial relations between two countries. The respondent who made this suggestion believes that the strengthening of the FCN treaties to cover the issues of concern to the services sector may obviate the necessity of new agreements.

Several participating firms, mainly from Europe, but including others from Canada and the United States, oppose any bilateral approach to removing trade barriers. They are concerned mainly that bilateral efforts will weaken or even break down the multilateral trading system that they believe is necessary to the world today. Country-by-country trading rules will in their view, jeopardize the establishment of uniform trading regulations that are necessary to prevent competitive distortions of the world trading system.

Bilateral agreements, other respondents contend, fail to reflect the global nature of many services businesses such as banking, telecommunications, air transportation and ocean shipping. Because these services operate in a world market, fragmented bilateral approaches to removing obstacles are unwieldy, complicated and confusing.

Finally, as a Scandinavian executive asserts, bilateral negotiations are disadvantageous to small nations. A small nation cannot bring the necessary clout to bilateral negotiations when dealing with much larger nations. This disparity can be overcome, at least in part, in multilateral negotiations where small nations can combine on issues of common concern.

Industry-specific Bilateral Agreements

Bilateral negotiations covering one specific industry or a related group of industries receive much more support from survey participants than do general bilateral negotiations covering all services industries. While slightly more than one in ten of the responding companies support the general bilateral approach, more than one-third support the industry-specific approach by itself or in conjunction with an existing multilateral

Reported Advantages of Alternative Approaches to Eliminating Barriers to International Trade and Investment in Services

GENERAL	INDUSTRY-SPECIFIC
In principle no difference between trade in goods and services. This is better understood and clarified by a general approach. Because services trade is becoming increasingly intertwined with goods trade, regulating their trade together will be more effective and more efficient. A general approach is more flexible, allows more effective trade-offs in negotiations, and, therefore, gives better chance for success.	Real distinctions exist between goods and services and among services themselves. They can best be handled in industry-specific negotiations. Experts on particular industries can be used more effectively. Less chance for sacrificing interests of one industry to gain benefits in another. Gives more attention to interests of the smaller industries in the services sector. Less complex and clumsy than dealing with many industries at one time. Negotiations can be concluded more quickly. Decisions more readily enforceable.
MULTILATERAL	BILATERAL
Recognizes global nature of many services industries. Negotiations in this context can establish uniform trading regulations for whole world and thereby strengthen world trading system. Easier to see that all nations receive equal treatment. Less fragmented, confusing and unwieldy arrangements. Effective forum for small nations that have no clout in bilateral negotiations with large nations.	Easier to consider country-by-country differences in services industries. Can consider national cultural differences. Each negotiating partner can focus on other countries of greatest interest to itself. Can limit or exclude irrelevant political issues that enter into multilateral negotiations. More manageable than multilateral because less complex. Can be concluded more quickly. Less costly. Can be used as precedent for later multilateral negotiations.
EXISTING	NEW
Established organization and bureaucracy with procedures and experience. Has existing body of decisions that can be used as precedents in new trade issues. More efficient. Can act more quickly. Less costly. Successes in past give more clout to applications of principles and standards to new trade issues.	Better able to handle problems of emerging and expanding services industries. Can give more attention to less developed countries. Can establish more safeguards to prevent sacrificing the interests of some industries with less influence politically than others. Can act more quickly because not hamstrung by previous trade decisions and ongoing political disputes.

al organization that would expand its activities to include the services sector.

Among the individual services industries in this survey, the industry-specific bilateral approach is especially supported by the transportation and shipping group (68 percent), tourism services (57 percent), and the miscellaneous group of services (55 percent). More than a third of the industry respondents in banking and in business services also find this a useful alternative to improve trade in services.

The most frequently cited reason for the attractiveness of this approach, as could be expected, is the fact that it can be

targeted to the particular needs of a specific industry. The services sector covers a wide variety of industries linked together more often because they do not produce tangible goods than by any similarity in the services they do produce. This fact raises doubts in the minds of many respondents that the problems of international trade in their particular industry can be usefully resolved by linking them with dissimilar services industries in any kind of general negotiations covering the whole services sector. A U.S. engineering executive makes this point clearly: "There is little doubt that the engineering construction business is a service business that is quite different from

the other services industries, so any negotiation would have to be specific to our industry." The same point, only substituting the name of their own industry for engineering construction, is made by other U.S., Canadian and European executives in retail services, financial services, telecommunications and other industries.

Closely related to this concern is another reported by executives of firms in smaller services industries. They believe that negotiations covering all services industries will overlook the special needs of the smaller industries. A travel services executive, for example, believes the interests of the financial services industries (banking, insurance and nonbanking financial services) would overwhelm those of the travel industry if the two distinct groups are linked together in some kind of general negotiation.

A Canadian executive of an insurance company that operates in one services industry (insurance) in one foreign market (the United States) stresses the importance to his company and to those in similar circumstances of limiting negotiations to a bilateral, industry-specific approach. Besides considering the differences among industries, this approach allows negotiators to consider differences among individual countries and, where relevant, between categories of countries—such as developed and less developed. By limiting negotiations to specific industries and countries, irrelevant political issues can be excluded or at least reduced in significance along with the trade-offs that often result from the introduction of such issues to negotiations covering many industries.

The point that bilateral negotiations, whether industry-specific or covering all services industries, will be more quickly concluded with success than any kind of multilateral negotiations is made by many respondents. The factor of delay in negotiations is more often attributed to the number of countries involved than to the number of industries being covered, although an increase in the number of industries included in negotiations is seen as having some, but less significant, delaying effects on negotiations.

The arguments of opponents to the industry-specific bilateral approach are the same as those reported by opponents to bilateral negotiations on all services industries together: the trading system will become increasingly fragmented, weakened, unwieldy and confusing.

Industry-specific Multilateral Agreement

Fewer than half the number of companies supporting an industry-specific *bilateral* approach support an industry-specific *multilateral* approach. The main reason for this is the belief that several multilateral agreements and the resulting network of administering organizations will be much too costly for the limited benefits achieved by dividing an existing (or planned) general multilateral organization into several industry-specific multilateral organizations. A multilateral arrangement, furthermore, cannot consider individual country differences to the same extent as bilateral arrangements without becoming unduly complex.

Thus added to the cost argument is the belief that setting

up several new organizations will result in a trading system that would be complicated, confusing and inefficient—and would take much too long to solve trade problems in the services sector that need solutions now.

Support for the industry-specific multilateral approach is based on points similar to those reported by proponents of industry-specific bilateral arrangements: recognition of the important differences between services industries; more expertise available for solving the trade problems of one targeted industry than can be considered when all services industries are lumped together; and action for one industry can be taken more quickly than for all.

An added argument particularly favoring multilateral negotiations over bilateral is made by a European insurance executive. Small countries find it easier and more advantageous for their trading interests to negotiate with the support of other small nations in a multilateral context.

An Existing Multilateral Trade Organization

Working through an existing multilateral trade organization expanded to include the services sector draws the endorsement of the largest number of participants in the survey. Some 40 percent of the respondents support this approach—alone or coupled with one of the other suggested approaches, most often the industry-specific bilateral approach.

Support for this alternative shows a significant regional distinction: While approximately one-third of the U.S., Canadian and "other country" respondents support this approach, two-thirds of the European participants endorse it.

When considered according to the number of industry responses in this survey, the support for this alternative is still stronger: More than 70 percent of the companies in business services and in telecommunications support this approach, as do more than half the firms in transportation and shipping, tourism, nonbank financial services, banking, and professional services.

Only in insurance, retail stores and the "miscellaneous" group of services do fewer than half the firms consider this alternative as the best means to eliminate trade barriers in their fields of interest.

The wide support among participants for this approach is explained by several factors:

- Trade in goods and services should be linked together in one organization to demonstrate that "in principle" there is no difference between these two kinds of products. By lumping them together both developed countries and, more importantly, less developed countries will see how the two kinds of products are tied together in one trading system. Negotiating on *all* internationally traded products in one organization will be more effective in eliminating trade obstacles than would be any effort at piecemeal solution—industry by industry or separating goods and services.

- An existing organization will already have a body of decisions on trading matters that can be used to guide future decisions. There would be no need to reinvent basic international trade principles and standards. They have already been estab-

lished and recognized, thereby providing fundamental stability to the international trading system.

— Using a successfully functioning multilateral organization will make it easier to see that all nations receive fair and equal treatment in international trade.

— Expanding an existing organization to include more industries and, possibly, more countries will give it more clout to implement effectively the principles and standards it sets up for improving the international trading system.

— Using an existing organization with established procedures and experienced bureaucracy will be more efficient, and, therefore, less costly than setting up a new organization with a new bureaucracy.

The opponents to use of an existing multilateral trade organization to remove obstacles to world trade in services believe it is a mistake to lump goods and services together. They believe such linking makes such an organization too complex and clumsy to be effective as a means to eliminate barriers to services trade and increases the chances of a breakdown in any efforts toward that goal. Even if there is no complete breakdown, the process of resolving international trade problems will be greatly slowed when so many disparate industry and national views must be taken into account. The difficulties of enforcing guidelines developed primarily for the goods industries will be greatly increased when applied to the less clearly defined and often intangible service industries. Finally, several opponents believe that putting all industries together in one large existing organization may lead to sacrificing the interests of some industries to promote others, and they fear the possibility that the interests of their own industry and firm may be the ones sacrificed. One transportation executive explains this view: "Transport—and air transport in particular—is still too vital worldwide to be subjected to the vagaries of tradeoffs against wheat or oil or information and telecommunications technology. The air-transport sector does not always behave according to established principles of economics, is highly capital intensive and, therefore, vulnerable. Our strong preference would be to have air transport remain totally outside the scope of any general international trade agreement."

What Existing Organization Should Be Expanded?

As might be expected, considering that preliminary talks on including services within its area of responsibility have begun, GATT is the existing organization with the most support. Thirty-five companies suggested adding services to the responsibilities of GATT. Second, but with only seven proponents is the Organization for Economic Cooperation and Development (OECD). Several of those who choose OECD refer specifically to the potential expansion of its Code of Liberalization of Current Invisible Operations, adopted in 1961. This code covers trade in international services, at least in principle. But OECD members have attached so many reservations to its use that much effort would need to be expended to make it an effective instrument for the elimination of barriers to the services trade in today's world.

The European Economic Community is suggested by six companies (all European) as the appropriate organization. The International Monetary Fund is proposed by two banks. The Bank for International Settlements, the United Nations Conference on Trade and Development (which already has a code on one services industry—shipping), the International Shipping Federation, and one nongovernmental organization, the International Chamber of Commerce are each suggested by one responding firm.

In addition to the reasons already given above for choosing an expanded existing multilateral organization as the best means to eliminate barriers to services trade, GATT draws support largely because it is seen as an experienced organization, firmly established, with a broad membership, and a record of success in eliminating tariff barriers and reducing nontariff barriers to international trade in goods. Its achievements in the form of codes and accepted principles have been incorporated into the national laws of many of its member nations. In the view of many survey participants, this record gives GATT more chances of success if it were used to provide oversight to trade in services as well as in goods. An executive of a U.S. professional services firm illustrates this view: "The GATT is the preferred instrument because it has significant experience in international commercial matters, a broad membership, and recognized dispute-settlement and enforcement provisions—all of which are critical to the effectiveness of a services trade and investment regime."

Against the expressed support for GATT, however, several other survey participants make explicit reservations about its usefulness for ending trade barriers for the services sector:

— GATT negotiations take too long.

— GATT is already too broad and complicated to be completely effective. Adding the services sector to its agenda will further decrease its effectiveness.

— GATT has been concerned so far with traditional goods manufacturing industries and is the wrong forum for the new information-based industries.

— "GATT negotiations are frequently subject to political retribution that extends beyond business economics." (A U.S. transportation company.)

— "Organizations like GATT seem to be poorly adapted to serve underdeveloped countries fairly on a one-to-one basis with developed nations." (A Latin American entertainment company.)

One way to overcome the limitations to using GATT for services is suggested by more than a dozen of its supporters. The multilateral arrangements of GATT and the industry-specific bilateral arrangements favored by the second largest number of survey participants could be joined together into an integrated system to regulate international trade and investment in services. A U.S. accounting firm executive makes this point: "The best means of reducing or eliminating impediments to the international operations of accounting organizations is to negotiate multilateral rules through the General Agreement on Tariffs and Trade. The negotiations should lead to a framework agreement with general principles applying to all services and sector agreements adapting and implementing these

general principles to the requirements of specific service industries."

Suggestions to Negotiators

Participants in the survey were asked an open-ended question on what advice they would give to their countries' negotiators preparing for any future negotiations to eliminate obstacles to international trade and investment in services. More than half the respondents replied with specific suggestions, some of which apply to particular industries. Among these are: Eliminate subsidies and preferential loans in offshore construction; lift national restrictions on transborder data flows for the telecommunications and banking industries; provide a unified documentation and classification system for the shipping industry; eliminate governmental cargo reservations (also for the shipping industry); promote the harmonization of national banking regulations; and for two banks, keep their industry out of any new GATT negotiations.

The majority of suggestions, however, are more general. Most frequently suggested is the request to push for the most open and free trade possible for all services industries with equal access to all markets in all countries.

Second, negotiators are urged to seek reciprocity in services trade. Each nation should grant only those trade privileges it receives from others and should be allowed to restrict its services imports to the extent other nations place restrictions on its exports to them.

Third, participants advise their negotiators to promote the principle of national treatment, that is, foreign national firms are to receive the same treatment as domestic firms in the same industry within the nations party to the trading agreement.

Fourth, governments joined in any new trade negotiations should permit representatives of the industries concerned to participate in the negotiations.

Fifth, and directly related to the fourth: If the participation by industry representatives in the negotiations is inappropriate, then government negotiators should be more thoroughly briefed before and during negotiations on the positions of *all* the industries to be covered in the negotiations and not just on the large industry groups. For the services industries as a whole, the negotiators should be informed about the growing importance of the trade in services compared to the trade in goods with which international trade negotiations have traditionally been more concerned.

Sixth, for federal governments, such as the United States and Canada, negotiators should be fully aware of the regulatory roles and responsibilities of their sub-national governments for particular services including insurance, banking, construction, and professional services requiring state or provincial certification.

Each of the above six suggestions was made by four or more respondents, but many other suggestions were made by fewer participants. They include:

- Be prepared to open negotiations to new issues not considered in any earlier negotiations involving trade in goods
- Promote the right to establishment for services indus-

tries that need to produce their products at the place where they are consumed.

- Consider general international economic factors, such as more balanced national growth and exchange-rate stability, as they affect the services trade.

- Be ready to take a tough negotiating stand including a willingness to retaliate, but make that stand clear to other negotiating countries. Do not launch surprises at the negotiating table.

- Keep negotiations short. Do not let them drag on until they themselves become an impediment to success.

- Include the protection of intellectual property as part of any new negotiations on trade in services, and remember that other less directly related issues, such as those involving agriculture, are also part of the overall trade-negotiating endeavor.

- Protect cultural sovereignty especially against the dominance of foreign firms in such areas as publishing and entertainment.

- Recognize the difference between services performed within one country (e.g. resort hotels or construction) and those regulated jointly by two or more governments (e.g. air transportation and telecommunications).

- Study existing bilateral agreements covering services as possible precedents for a new multilateral agreement.

- Use all available tools for negotiating. For example, do not hesitate to link continued GSP (Generalized System of Preferences) benefits to opening markets to services trade.

- Trade negotiations should be insulated as much as possible from political pressures resulting from changes in political leadership.

- Eliminate local ownership requirements.

- Continue to collect information on what are really the barriers to international trade and investment and where they exist.

- Eliminate existing barriers to services trade and investment among political subdivisions at home first.

- Insure equal treatment in the world's trading system for both developed and less-developed countries.

- Negotiate agreements that can be enforced effectively and that will last.

- Before getting too involved in services, act to reduce the growing worldwide protectionist trend involving trade in goods.

- Finally, an important piece of advice as summed up by an air transport executive: "While urging an equitable but tough policy, do not fear change."

The executives submitting these suggestions clearly recognize that, while sharing many common concerns and generally accepted trading principles with producers of goods for international trade, the services industries have several different areas of concern that need different approaches for their resolutions. Underlying their replies is the implicit (and in some instances, explicit) belief that international trade should be kept as free as possible, but that some remedies, either bilateral or multilateral, are needed to foster greater fairness for all participants in that trade.

The 1987 Economic Outlook: No Recession, No Resurgence

Summary of a meeting of
The Conference Board Economic Forum

Management Summary

- The Forum consensus points to a "more of the same" forecast for 1987—more of the same moderate growth in economic activity and more of the same inflation and interest rates we have now.
- Underneath this surface tranquility lurk strong crosscurrents, especially in consumption and international trade. Although consumers will not reverse course, they are expected to play a passive rather than an active role in next year's economic advance.
- Foreign trade will step into the leadership role, however, as our import-export balance takes a turn for the better. The shift will be gradual, but a modest change in direction is all that's necessary to add a sizeable increment to the U.S. growth rate.
- A number of serious policy issues threaten this favorable outlook, including the budget deficit, monetary policy, and protectionism. These dark clouds are on the horizon, however, not massed directly overhead.

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An Uninspiring but not Unsatisfactory Forecast

Edgar R. Fiedler

Members of The Conference Board Economic Forum, convening in mid-November for their annual discussion of the business outlook, found themselves pretty much in agreement on a "more of the same" forecast for the overall economy in 1987. They look for more of the moderate and fairly steady advance in total activity that has prevailed since mid-1984, and more of the present level of inflation and interest rates. (For numeric projections, see table on page 4.)

This no-change forecast for the economy as a whole does not mean that no change is taking place *within* the economy. Quite the contrary. Beneath the apparent tranquility on the surface, strong crosscurrents are at work in almost every important sector. Residential construction, for example, which was first a contributing and then a sustaining factor during 1986, will weaken in 1987 when tax reform pulls some of the props out from under multifamily housing starts. Business capital investment, which dropped sharply in mid-1986—predominantly in the oil patch where capital outlays plummeted a breathtaking 40 percent—should stabilize or move slightly upward next year. Business inventories, a drag on output since early this year, are seen as providing some forward thrust during the year ahead.

By far the most important shifts in direction will take place in personal consumption and foreign trade. These two sectors are clearly the keys to the 1987 outlook. Consumers have been the driving force behind the expansion throughout the past year, with spending growth that far outpaced the rest of the economy. In the process they've drawn down their saving rate to well below normal, which suggests that they have no reserve buying energy left to contribute to economic advance in 1987. In addition, surveys of consumer sentiment now show a lack of exuberance. From here on, despite the lift tax reform will impart to disposable income at the beginning of the year, the consumer has to be thought of as a passive agent in shaping the 1987 economy. Total personal outlays will continue to rise, but more slowly than in 1986.

The slack should be taken up by foreign trade. The international worm is beginning to turn. The import binge we've been on is slowing, and exports are strengthening in a variety of industries—wood products, textiles, chemicals, machinery and others. The change will be modest and gradual, to be sure, and not all our trade-troubled industries will see much improvement. But where deterioration in the trade account cur-

tailed GNP growth sharply in 1986—pulling a growth rate that would otherwise have been 3.5 percent down to a rather ordinary 2.2 percent—the reversal now in progress will boost output in the year ahead. Even a modest shift in direction will add a sizeable increment to the U.S. growth rate.



Edgar R. Fiedler

"The dark clouds are not massed directly overhead."

What all these changes in direction among the major sectors add up to is not easy to discern. Bruce Lippke compared forecasting the economy under these circumstances to a quarterback trying to pass the football in a blizzard: A tough task made tougher by poor visibility and slippery footing. But as best the Forum members can judge, the pluses and minuses offset one another in a surprisingly evenhanded way. As a result, the United States economy seems to be headed for another year of moderate expansion—at a growth rate of about 3 percent. Although this is an uninspiring pace of advance, it is not unsatisfactory. Moderate growth is preferable to vigorous expansion, if the latter leads, as it might, to more inflation or an early downturn.

It is, of course, not difficult to alter this projection in either direction. A forecaster needs only to assume a slower turnaround in the trade balance and some purse-tightening by consumers and—Poof!—the projected expansion vanishes. Alternatively, a faster pick-up in foreign trade and just a bit more of a free-spending mood by consumers would impart a nice glow of buoyancy to growth in 1987. The Forum doesn't rule out those two possibilities, but most of the group feels that either a business cycle downturn or a full-fledged boom is unlikely.

For this same reason—no recession but no resurgence either—inflation is unlikely to be dislodged very far from its

average pace of the past few years. In early 1986, the dramatic drop in oil prices brought about an actual decline in the consumer price index. Yes, that's right, not just disinflation but deflation! In recent months, however—once the price of oil stabilized and the direct effects of its decline had worked their way through the system—the CPI has begun to climb again, at about the 3.8 percent rate of 1985.

Members of the Forum are divided on whether 1987 is likely to see inflation accelerate slightly or decelerate slightly. On the upside, rising prices of imported goods—reflecting the declining international value of the dollar—could lift the inflation rate a notch or two. Others argued that, with unemployment near 7 percent, the economy has sufficient slack to bring additional disinflation to both wages and prices. In either case the effect is seen as modest.

The same pattern applies to interest rates. In the context of our expectations for the economy and inflation, demand and supply in the credit markets are seen to be in close balance. Will the Federal Reserve change this? Maybe, but for now the group sees the Fed more or less equally concerned about recession and inflation, which also suggests little movement in interest rates. Accordingly, although there are different views about the direction of interest rates, the differences are narrow.

Policy Dilemmas

The Forum also chewed on a number of structural issues, most related to economic policy, that seriously threaten the long-run stability and viability of the economy. The discus-

sion of tax reform, for example, identified so many conflicting effects on specific sectors of the economy that the macroeconomic impact seems almost indecipherable. From a long-range perspective, all or nearly all of the group favor the legislation, but for somewhat different reasons and with significant reservations.

The budget deficit poses several uncertainties. The Gramm-Rudman-Hollings legislation is a dead duck—killed by the indecent transparency of the bookkeeping artifices used to meet its target for fiscal 1987. The corpse has no death certificate, however, and the undertakers won't take it to the morgue. Thus no one sees the uptrend of government spending returning to its business-as-usual pace of earlier years. At the same time, chances are remote that Congress will enact either program cuts or tax increases in 1987. Whether new additions to spending can also be avoided is one uncertainty. If so, the budget deficit appears to be locked onto a stable or gradually declining path—the path that was forged over the past two years by the drastic slowing of the military build-up and the curtailment of a number of domestic programs. The dilemma here is that while the disappearance of the Gramm-Rudman targets relieves anxiety that a too-rapid move toward fiscal restraint would push the economy into recession, it also leaves in place large chronic deficits that pre-empt the capital investment needed to improve the nation's sluggish productivity trend.

Monetary policy provides its share of perplexity, too. One difficult question is why the interest-rate decline of the past couple of years has not produced a greater cyclical response in the form of stronger economic expansion than seen to date.

The Forum Consensus
Results of a Pre-Meeting Outlook Survey

	Actual 1985	Actual III 85 - III 86	Fourth Quarter 1986	Projected	
				1987	
				Median	Range
Economic Growth (Real GNP, percent change)	2.9	2.2	3.0	3.0	1.5 to 3.2
Inflation Rate (GNP Deflator, percent change)	3.3	2.9	3.1	3.8	3.5 to 4.0
Corporate Profits (Before taxes, percent change)	7.8	2.9	7.9	6.5	5.0 to 13.5
Unemployment Rate (Percent, average during fourth quarter)	7.0	6.9	6.9	6.7	6.5 to 7.2
Commercial Bank Prime Rate (Percent, average during fourth quarter)	9.5	7.8	7.5	7.6	7.0 to 8.5
	Actual FY 1986		Projected		
			FY 1987	FY 1988	
Federal Budget Deficit (Billions of dollars)	221		188	170	

Note: These forecasts incorporate submissions by Forum participants in early November, and are based on data available at the time. For growth, inflation and profits, the annual forecasts are the percent change over the four quarters of the year, i.e., from 1986 IV to 1987 IV; the forecasts for the fourth quarter of 1986 are at seasonally adjusted annual rates.

The answer *may* be simply that declining interest rates did in fact provide their usual stimulus to the economy, but the deteriorating trade balance and other forces imparted more offsetting restraint than we recognize. But perhaps not, and the question remains whether what we once thought to be a fairly reliable link between monetary stimulus and economic expansion is still intact. If not, will monetary policy, now evidently the only major discretionary policy tool available, have the capability to attenuate and reverse quickly the next recession when it appears?

A similar question concerns the way monetary policy is carried out. Since 1979, the Federal Reserve has paid increased attention to the rate of growth in the monetary aggregates. Recently, however, the relationship between economic activity and the various measures of money supply appear to have lost some of the reliability once ascribed to it. Consequently, the monetary authorities now must focus less on money growth as a dependable steering mechanism for guiding the economy and instead depend more heavily on interest rates and various indicators of economic performance. As Lyle Gramley put it, they must fly more by the seat of their pants. The risk of veering off course into recession or inflation may thus be greater than we used to believe.

Finally, our international policies pose uncertainty. One thing that's not clear is which industrial country might serve as the "locomotive" to pull the world business cycle onto the track of faster expansion. More likely, as Eric Kruger noted,

the railroad metaphor is inappropriate; the present situation is better described as a disorderly mule train!

The absence of vigorous growth in the industrial world exacerbates two important problems. One is the heavy debt burden of some developing countries, whose recovery to economic health will be slower and more painful.

The second is the threat that serious protectionist measures may be put in place. In the United States, the decline in the exchange value of the dollar and the shift of direction in the trade balance will reduce the pressure for new barriers to imports in many industries, but not all. Forum members agree on the importance of both "free trade" and "fair trade"—which are in fact the same thing. But they worry that the hard bargaining necessary to gain unfettered access to specific foreign markets could backfire in ways that would lead to more rather than fewer barriers to international trade, thus compromising both goals.

In the end, none of these dilemmas and uncertainties about economic policy deterred the Forum from projecting further moderate growth for 1987 with no substantial dislocation of the present structure of inflation and interest rates. The policy concerns are serious, but the threats they represent to the economy do not appear to be imminent. Indeed, none of the participants looks for the next business recession to get underway until 1988, and most think it will be 1989 or later. The group has no difficulty finding dark clouds on the horizon, but for now at least they are not massed directly overhead.

The Cyclical Setting

Albert T. Sommers

Midway in the final quarter of 1986, the U.S. economy is giving a reasonable but still unconvincing account of itself. For the past six weeks, it has been experiencing a seventh bubble-like revival of statistical growth; all the other six bubbles of optimism since the system turned sluggish in the middle of 1984 evaporated in a matter of months. And it is not clear yet whether the present improvement will avoid the fate of its predecessors.

This latest bubble is composed of a better level of manufacturers' orders, widely distributed among industries, and a considerable improvement in shipments — in the presence of little or no change in inventories, so that inventory-shipments ratios have declined. Employment has continued to grow at a 2 percent annual rate. Retail trade has been moderately strong (extremely strong if the special strength in the automobile market were not to be excluded) but demand in most of the other sectors of the domestic economy seems on the whole to be no better than stable, and the flow of personal income that must support the growth of the personal outlay has been strikingly low.

These modest and rather sparse indications of faster growth in the domestic economy have been reinforced, this time around, by better evidence with respect to its international behavior — some degree of strengthening of the dollar against

Albert T. Sommers

"Sparse indications of faster growth."



both the yen and the mark, two consecutive months of decline in the trade deficit (reflecting some subsidence of imports, but no real growth for its own exports) and bilateral arrangements

with the Japanese that included a reduction in the Japanese bank rate, and some assurances that it will seek better growth for its own economy. It is these international considerations, more than the thin collection of more favorable evidence on the domestic economy, that lend some substance to the modest indications of growth that can be found in recent figures.

All of this does not add up to a portrait of the beginning of cyclical growth; in fact, the traditional cyclical behavior of the system that rests on fast transmission of strength and weakness from one sector to another has been strangely absent for over two years. It is as though the interconnections among the parts of the system have been blocked or attenuated. The business cycle is predominantly an industrial phenomenon, and predominantly a goods phenomenon; it gains its strength from the interconnections between goods demand, inventory demand and the resulting capital goods demand. Viewed this way, it seems pretty obvious that the development of the huge

trade deficit of the past few years has numbed the cyclical machinery of the system, insofar as real demands are concerned, and its suppression of price strength in the industrial sector has killed off the the speculative and anticipatory demands.

To develop into a more nearly cyclical growth rate in 1987 would therefore seem to require a significant and persistent decline in the trade deficit. But even forecasts (such as my own) that envision a considerable degree of reduction in the deficit nevertheless generate only moderate growth, since the responsiveness of a number of other sectors — plant and equipment, housing, the rate of Federal outlay for goods, and perhaps even consumption demand — is unlikely to improve importantly in the near term, even under conditions of a subsiding trade deficit. The most likely course for the economy, therefore, is for very sluggish performance in the first half of 1987, and then a return to 3 percent growth almost a year from now.

Politics And The Economy

Isabel V. Sawhill

According to the Democrats and some columnists, the 1986 election marked the end of the Reagan era and of a trend toward greater conservatism in our national life. This is too strong a conclusion. First, the election was about local issues and personalities; it wasn't a referendum on anything. Second, the Democrats have been at last partially "Reaganized." They're not talking about new spending programs, raising taxes, or cancelling SDI. Third, the Republicans took over 8 of the statehouses and suffered far less of an electoral loss than is typical for the out-party in the sixth year of an administration. Fourth, in spite of the surprising Democratic pick-up of 8 seats in the Senate, many of the new Chairmen — especially on such key economic committees as Appropriations, Finance, Budget, and Commerce — are as conservative as the Republicans they are replacing. Finally, exit polls show that the number of voters who describe themselves as Republican or "conservative" has drifted up since 1980 and that a plurality of voters think that the Republicans do a better job than the Democrats at handling the economy as well as other issues. Thus the election provides no mandate for the Democrats to go back to business as usual.

Nevertheless, there are signs that the voters are both weary of, and wary of, ideological solutions to the nation's problems. The public is looking for a government that *works*, whatever its size. Supply-side economics is, if not dead, certainly moribund. Support for the religious right's candidates and issues appears to be minimal. Concern about the budget and trade deficits remains high, though the public doesn't really understand these issues and is easily turned off by abstract discussions of them.

The 100th Congress will have to deal with these concerns. Both deficits are expected to peak in 1986 and gradually decline thereafter, barring a recession. This will remove some of the pressure to do something about them — probably a good thing in the case of trade but a bad thing in the case of the budget.



Isabel V. Sawhill

"On the budget, continuing stalemate."

Democrats have put trade at the very top of their agenda. Senator Lloyd Bentsen (D-Tex.), the new chairman of the Senate Finance committee, is promising action by spring and will likely get support from such key Republicans as Sen. Robert Dole (R-Kan.) and Sen. John C. Danforth (R-Mo.). Although he is pro-business and not an outright protectionist, Sen. Bentsen sponsored last year's bill that would have put an import surcharge on goods from countries that restrict imports from the U.S. Access to foreign markets is likely to be the centerpiece of any legislation. The President would almost

certainly veto anything that smacked of protectionism, but he only barely succeeded in blocking the textile bill last year, suggesting that the Congress may win this one in 1987.

Unlike politicians, most economists think the solution to our trade problems will come not from trade legislation but from getting the budget deficit under better control. Unfortunately, prospects are for continuing stalemate on this front. The President is likely to hang tough on defense and taxes; the Congress has already curtailed his defense requests substantially with the result that defense outlays are now on a downward path as a proportion of GNP; social security is off limits; there's not much left to go after in the rest of the budget; and few think the Democrats will be brave enough to propose raising taxes in the face of continued White House

opposition. An oil import fee could produce some revenue and there might be an attempt at further base-broadening as part of a second round of tax reform, but this wouldn't be any easier to pull off than round one. Thus, in place of real progress on the deficit what we are likely to see is more discussion of the budget process itself, including Gramm-Rudman, which may be scuttled in the face of a large gap between the target for FY1988 (\$108 billion) and the deficit projected for that year (\$170 billion?). It will also be argued that complying with the targets could be bad for the economy in the short run.

All in all, it is not an encouraging picture. If the economy continues to recover, it will be because of its natural robustness and not because anyone in Washington (other than the Fed) is taking constructive action.

Thoughts on Tax Reform

John H. Makin

I wish to draw four conclusions regarding tax reform: It will not precipitate a recession. It does not represent an ideal income tax code, but it probably realizes about half the gains available from thoroughgoing reform of an income-based tax system. Its major strengths are its increased incentives for economically motivated, rather than tax motivated, decisions by households and corporations and the incentives it provides to reduce the build-up of private sector debt that now threatens continued economic recovery. Its major weakness is its failure to index provisions related to the taxation of income from capital. Faster inflation would reduce investment incentives because of the bill's failure to index capital gains, depreciation measures, and inventory allowances.

On the first of these points, weakness of the economy has raised the fear that we may be poised on the brink of a recession. Therefore, it is said that the reform legislation, by increasing the tax burden on corporations especially through the rescission of the investment tax credit, will push the economy over the brink. We may well be facing a recession, but public-sector debt accumulation (budget deficits) and private-sector debt accumulation (trade deficits) are the culprits, not tax policy.

The legislation raises the cost of capital by between 5 and 10 percent if it is assumed that interest rates are unaffected. Nevertheless, the lower tax rates and limitations on household borrowing will slow debt accumulation and produce lower interest rates. The impact on the cost of capital will be small, if there is any at all.

If the repeal of the investment tax credit (ITC) were unanticipated, it would produce a temporary, negative impact on capital formation. It is likely that the removal of ITC has long been anticipated and that its major negative effects appeared during the first quarter of 1986 when nonresidential fixed in-

vestment fell at a 15.1 percent annual rate. The decline slowed to a 2.3 percent annual rate in the second quarter. Since 1962, when the ITC was first employed, it has been modified, suspended, and reenacted eight times. The expected life of an unamended investment tax credit is two to three years. Therefore,



John H. Makin

"Reintroduction of ad hoc corrections is a major risk."

its removal five years after its last modification in the Economic Recovery and Tax Act of 1981 should hardly come as a surprise.

The reform bill forgoes, presumably for sound political reasons, two major base broadeners: the preferential treatment of owner-occupied housing and full deductibility of state and local taxes, other than sales taxes. These exceptions to base broadening relinquish \$70 to \$80 billion per year in potential revenue and thereby limit achievable rate reductions and preordain an increase in corporate taxes to finance politically attractive and economically useful tax rate reductions for households and businesses.

A closer-to-ideal reformed income tax system would be the Treasury I plan of November 1984 with preferences for owner-

occupied housing removed. Total welfare gains under such a plan would be roughly double those achievable under the conference agreement.

Through rescission of the investment tax credit, lower corporate tax rates and lower tax rates on households, tax reform sharply reduces the disparity across tax burdens on alternative forms of investment. The agreement therefore increases the incentive for scarce investment funds to be allocated to projects that are intrinsically attractive from an economic standpoint rather than from a tax perspective.

The bill's lower tax rates and limitations on household borrowing will slow private-sector debt accumulation. The lower rates themselves plus the slower rate of debt accumulation place downward pressure on interest rates that help to compensate for the increased tax burden on new capital purchases, resulting largely from rescission of the investment tax credit.

The weakest feature of tax reform is its failure to insulate the level and distribution of tax burdens on investment from changes in inflation. Accelerated depreciation, investment tax credits, and low tax rates for capital gains have in the past evolved as ad hoc corrections to "capital bracket creep." When inflation drives up replacement costs, unindexed depreciation schedules and inventory allowances leave corporations with artificially bloated profits and tax bills. Investors with paper gains on assets whose value has risen only with inflation pay taxes where none should be due. These shortcomings could be remedied with indexing provisions.

The major risk from "capital bracket creep" is that higher inflation will increase pressure to reintroduce these sorts of ad hoc corrections. This pressure will mean reopening the tax

code every year or two as has become an unfortunate practice. The resulting increased tax code uncertainty penalizes investment by making difficult long-term planning regarding after-tax rates of return.

Summary

The legislation represents progress toward a more stable, less intrusive tax system. It signals a less activist role for government through the tax system, just as airline and trucking deregulation, an end to oil price controls and deregulation of financial institutions have marked a less activist role for government by other means. It also ends half a century of unsuccessful efforts to redistribute income through progressive taxes.

Looking ahead, one should keep in mind three facts that link the budget to the tax code: First, without a willingness to slow the growth of entitlement programs, required progress on deficit reduction will necessitate a tax increase. Second, an increase in the tax burden on capital above that incorporated in the reform bill could not be compensated for by lower interest rates and therefore would result in a net increase in the cost of capital and a slowdown in growth that would further increase the deficit. Third, in addition to large government dissaving represented by large deficits, America's private saving rate remains distressingly low. In sum, a country in need of revenue that saves too little ought seriously to consider eliminating or at least reducing the double tax on saving by enacting an expenditure-based tax system, such as a value added tax or a GATT-legal business transfer tax.

The Federal Budget

Van Doorn Ooms

It will no doubt be regarded as a sign of either imprudence or special pleading to argue, only days after a record Federal budget deficit of \$221 billion for Fiscal Year 1986 was announced, that a remarkable change in the trajectory of total Federal spending has taken place in the last two years. Political rhetoric links large deficits to "uncontrolled spending," but the numbers show, in fact, a very sharp reduction in spending growth in the 1986 and 1987 budgets, principally driven by policy changes during the 99th Congress.

The spending slowdown has been obscured by the failure of the deficit to come down in 1986 and by the difficulty of reaching the unrealistic \$144 billion deficit target in 1987. However, this is due largely to slower revenue growth from a disappointing economic performance and to sharply raised outlays in farm-income-support and deposit-insurance programs.

The current Congressional Budget Office (CBO) projection for total Federal spending in 1987 is remarkable—an outlay

increase of only \$5 billion, or 0.5 percent. Spending growth now appears to be running well under that of GNP, whereas the opposite was true in 1981-1985.

Much has been made of the impact on the budget estimates of the "blue smoke and mirrors" used to reach the Gramm-Rudman targets—creative accounting that moves money between fiscal years, asset sales with only one-year effects, and optimistic forecasts. (Critics of Gramm-Rudman were correct in at least one respect. It strengthens Gresham's Law of Budgeting, by which bad numbers drive out good.) Reference has also been made to the effects of the tax reform legislation in adding \$11 billion to revenues in 1987—while removing \$17 billion in 1988. It's possible to get a better look at the "fundamentals" of the recent fiscal actions by adjusting for these factors.

The table shows adjusted spending and deficit projections with most of the smoke blown away, with the tax reform revenue effects removed and with an economic forecast resem-

bling the current "consensus," with lower economic growth than used by CBO in August. The longer term pattern does not change appreciably although the 1987 deficit is substantially higher and the 1987 spending slowdown slightly less dramatic.

What happened to bring about this change in the spending trajectory? The main elements have been:

- Greatly increased restraint on defense appropriations in both 1986 and 1987. Budget authority in defense stands at \$284 billion in the 1987 budget compared with \$295 billion in 1985; defense outlay growth should fall from 11 percent to about 2 percent over the two years.
- The level of non-defense discretionary spending was successively reduced in both 1986 and 1987. Outlays in these programs are projected to fall from \$172 billion in 1985 to \$167 billion in 1987. Projected 1987 spending in this broad area of domestic programs is at the same dollar level as in 1981, implying a reduction in the real aggregate program level of about 20 percent over the six years.
- The Gramm-Rudman sequestration in the 1986 budget reduced the spending base in that year, with larger effects in 1987 and probably subsequent years.
- Even the relatively intractable entitlement and other "mandatory" programs saw a substantial slowdown in the aggregate resulting from regulatory action in health programs, new farm legislation and the elimination of revenue sharing. These programs are growing at *half* the rate of

GNP in 1986-1987, whereas they grew significantly faster than GNP in 1981-1985.

Finally, what are the fiscal policy implications of the above? The table also shows structural deficits (cyclically adjusted to a 6 percent unemployment rate) associated with the projec-



Van Doorn Ooms

"The spending slowdown is real, but will the deficit fall?"

tions. The fiscal restraint is impressive. Indeed, some will wonder whether the imposition of restraint—on which the consensus seems firm as a long-run matter—is too rapid in 1987. Yet, the Gramm-Rudman deficit targets of \$108 billion in 1988 and \$72 billion in 1989 imply significantly greater restraint. Furthermore, the required restraint would grow if the projected deficits (as so often in the past) are higher than those above when the 100th Congress convenes to consider fiscal policy in January. A vigorous debate on Gramm-Rudman, and perhaps on fiscal policy, lies ahead.

Federal Spending and Deficits

(Fiscal years, \$ billions or percent)

	1985	1986	1987	1988	1989
<u>Unadjusted Projections</u>					
Spending	946	990	995	1057	1105
Deficit	212	221	151	153	127
<u>Adjusted Projections</u>					
Spending	946	989	1005	1052	1105
Deficit	212	220	184	149	134
<u>Cyclically Adjusted Projections</u>					
Structural Deficit	168	189	128	126	114
Percent of Potential GNP	4.1%	4.2%	2.8%	2.6%	2.2%

Monetary Policy

Lyle E. Gramley

The Federal Reserve's policies in 1986 have clearly been oriented toward ensuring a satisfactory growth rate of the U.S. economy. In the February report to the Congress on monetary policy, the Fed indicated that members of the Federal Open Market Committee (FOMC) expected real GNP to increase by 3 to 3½ percent in the four quarters of 1986. During the next two months, the discount rate was lowered twice. In the July monetary policy report, the Fed indicated that real GNP growth over the four quarters of 1987 was expected to be 3 to 3½ percent. Within the next month and a half, two more reductions in the discount rate occurred.

Throughout 1986, the probability of recession in the U.S. economy has been small—nonzero, but small. Indeed, the economy has continued to advance at about the same moderate rate that has been in evidence since the middle of 1984. What explains the Fed's rather aggressive easing of monetary policy in 1986, particularly in light of the out-sized increases in the narrowly defined money supply?

The answer, I believe, lies in its judgment that economic growth among the major industrial countries is too slow. Growth of output in the industrial countries will be lower in 1986 than in 1985, and perhaps lower still in 1987 if activity in Japan and the U.S. does not perk up slightly. There is at least a remote chance that weak economic growth here and abroad will interact and produce a world-wide recession. Such an event would be a disaster. Even if that does not happen, growth of the industrial economies of less than 3 percent for a protracted period would offer little or no hope of satisfactory progress in resolving the debt problems of many developing countries. Those countries need the opportunity to increase their exports in the context of expanding world markets; otherwise, the threat of an international debt crisis will remain uncomfortably high.

Since August 21, 1986, the Federal Reserve has been marking time; no further easing actions have occurred. Signs of moderate improvement in the economy have developed, and the Fed clearly wants to wait and see whether the long-awaited strengthening of economic activity is at last underway. My expectation is, however, that economic growth will weaken again in early 1987, largely because of a diminished pace of consumer spending. Early next year, therefore, I expect to see further steps by the Federal Reserve toward ease, and moderately declining interest rates.

A major problem the Fed may have to face in 1987, and if not then in 1988, is deciding when to shift from a growth-oriented monetary policy to a policy posture aimed at the long-run objective of holding down inflation. A major problem it



Lyle E. Gramley

"Monetary policy is doubly difficult now."

will face in this respect stems from the difficulty of using the monetary aggregates as policy targets.

Historical relationships between the growth of money narrowly defined (M1), gross national product (GNP) and the inflation rate seem to have broken down. In its July 1986 report to the Congress on monetary policy, the Federal Reserve effectively abandoned its M1 target range for the remainder of this year and set forth only a "likely range" for 1987.

The broader monetary aggregates — M2 and M3 — have thus come to the fore as the principal targets of Federal Reserve policy, at least for the time being. Of the two, M2 has always been given greater emphasis by the Fed. Unfortunately, M2 is an elusive monetary policy target because so little is understood about the factors that influence its growth. And since M2 comprises four-fifths of M3, the latter aggregate is equally suspect as a target for monetary policy.

One of the puzzling facts of recent financial history is the stability of M2 growth. During the period from 1978 through 1985, the growth of M2 (measured fourth quarter to fourth quarter) was between 8.0 and 9.3 percent in seven of the eight years. Only in 1983, when M2 growth soared to 12.2 percent, was the pattern of exceptionally stable M2 growth broken. In 1986, it appears that M2 growth will once again be within the 8.0 to 9.3 percent range; from the fourth quarter of 1985 through September, the annual growth rate was 8.5 percent.

What makes this stable growth rate of M2 truly remarkable is that no one planned it that way. It just happened, and it happened even though the most important determinants of M2 growth — nominal GNP and short-term market interest rates — were fluctuating wildly. Nominal GNP growth during the eight years from 1978 to 1985 ranged from a low of 3.1 percent in 1982 to a high of 14.8 percent in 1978. Three-month Treasury bill rates were as low as 6½ percent in early 1978 and as high as 15 ½ percent in the middle of 1981. But M2 growth chugged along in every year but 1983 at between an 8.0 and 9.3 percent rate.

In recent years, the Federal Reserve Board staff (and it is a first-rate staff) has been studying intensively the forces that determine the growth of M2 and the other major monetary

aggregates. I am confident that they will eventually succeed in understanding these forces better than anyone does today. For the moment, however, establishing a target growth rate for M2 substantially outside the 8 to 9 percent range characteristic of recent years would be hazardous. No one could be confident of the course of monetary policy needed to achieve the desired result or what the effects would be on interest rates and GNP growth if the desired growth of M2 were actually achieved.

This is not a happy state of affairs. When monetary policy is deprived of a reliable monetary target, the monetary authorities have to fly more by the seat of their pants. The job of running monetary policy is difficult under the best of circumstances, and doubly so now.

Inflation: Steady at 3½ Percent

Phillip Cagan

Much to everyone's surprise we are doing very well on the inflation front. The consumer price index (CPI) in the third quarter of 1986 rose 2½ percent at an annual rate. This reflects 2 percent for commodities excluding fuel and energy and 4 percent for services (a welcome decline from a previously persistent 5 percent for services). The rate for all items was lower in the first two quarters only because of unsustainable declines in oil and other commodities. The employment cost index (compensation of private workers), my favorite indicator of the underlying momentum behind inflation, is down to 2¾ percent in the third quarter.

I published a book in 1979 (*Persistent Inflation*, Columbia University Press) reviewing the failure of the prior attempts of monetary policy to subdue inflation in 1966, 1969, and 1975 and, although then pessimistic about the prospects, I admonished the Federal Reserve to be more persistent in pursuit of an anti-inflationary policy. While I am too modest to take full credit for the subsequent stiffening of our policy, the inflation rate not only came down in the business recessions of 1980 and 1981-82 but, uncharacteristically, has declined further in the subsequent business expansion. We had not seen this countercyclical pattern since the inflation of the 1950s expired after the two recessions of 1958 and 1961.

An enticing explanation of why inflation has not escalated since 1982 is that gigantic budget and trade deficits came in to appreciate the dollar, which thus fortuitously reduced import prices and held down many other prices through intensified foreign competition. Now that the dollar is depreciating we could, on this explanation, face renewed inflationary pressures. While an index of import prices has indeed accelerated (the BLS import price index excluding fuels rose 7½ percent from mid-1985 to mid-1986, up from 2 percent the preceding 12 months), this has so far not led to higher inflation, allegedly

because of the offsetting collapse of oil prices (the BLS import price index including fuels fell 10½ percent in the year ending mid-1986). With oil prices recovering, the economy is now supposedly poised for renewed inflation.



Phillip Cagan

"The inflation premium in bond yields should gradually decline further."

Maybe, but I am skeptical of this view. First of all, the measured depreciation of the dollar appears far larger against OECD countries than against a more comprehensive group of our trading partners, weighted for bilateral trade or for multilateral trade to allow for third-country competition, and even in real terms to allow for relative inflation rates. Moreover, the depreciation of the dollar does not tell us how foreign competition has affected price decisions and profit margins.

To check on prices in industries especially subject to foreign competition, I constructed a price index based on 4-digit SIC manufacturing industries in which imports and exports were a quarter or more of the market and for which the BLS publishes an index of selling prices. Since 1979, as the dollar appreciated, the index I constructed rose 7 percent less than an index for all commodities excluding fuel and power (only

about 1 percent per year less). Since early 1985 it has remained 7 percent lower, despite the depreciation of the dollar. A similar comparison of wages shows no differential at all between foreign-competing and all industries since 1979. All of this indicates that profit margins rather than prices have absorbed most of the changes in the dollar.

If the dollar depreciation overshoots, as it may soon do given the lags in adjustment involved, it no doubt will have some intermediate-term effect on inflation. Also, fluctuations in commodities, particularly petroleum, will have short-term ef-

fects. But wage advances are weak and growth in unit labor costs is steady and could decline further. Consequently, the inflation rate is on a stable path of $3\frac{1}{2}$ percent or so, and will probably continue at about this rate through 1987.

Long-term bond yields of 8 to 10 percent remain at levels relative to short rates that protect against rates of inflation over the long run of 5 to 7 percent. The inflation premium in bond yields has declined irregularly since 1980 as skeptical market expectations have been won over by the progress against inflation, and they should gradually decline further.

The Labor Market in 1987

Arnold R. Weber

The labor market will continue to be a source of stability and moderation in 1987. This will be an extension of the trends that emerged in 1981-82, which dramatically reversed the situation that had developed during the 1970s.

Wages and compensation continued to moderate in 1986 and there shouldn't be any significant change in 1987. The increase in average hourly earnings for workers in the private sector is running at an annual rate of 3.3 percent, down from 4.5 percent in 1985. The advance in the employment cost index for private-nonfarm workers is down to 3.8 percent, from 4.7 percent last year.

There has not been too much difference between wage gains in manufacturing (3.4 percent increases) and non-manufacturing (3.9 percent). Increases for union members, however, have been running significantly lower (2.5 percent) than for non-union workers (4.2 percent). The only significant wage pressure is found in the public sector, in state and local government, where for the past two years wage increases have been running at 5.5 percent, reflecting a combination of the economic comeback of governments and union strength.

Productivity increases are running at a disappointing 1 percent. Thus unit labor costs will increase about 2 percent, or even less, depending upon what happens to aggregate output.

There seems to be nothing on the horizon that would dramatically alter this situation. Unions continue to be in an extended, if not indefinite, period of debilitation. The bargaining calendar poses no major threats. Indeed, some of the more generous settlements are behind us, such as communications and railroads. There has been a breakdown of some traditional bargaining structures, in particular fewer industry-wide set-

tlements. There has also been a shift to contingent increases through bonuses and other forms of gain-sharing.

By almost all measures, the labor market continues to have significant slack and is thus unlikely to exert upward pressure



Arnold R. Weber

"The bargaining calendar poses no major threats."

on wages or to create important bottlenecks. The overall unemployment rate is stuck at around 7 percent. The median period of unemployment has stayed at 15 weeks. Overtime in manufacturing is stable at 3.5 hours. Participation rates continue to increase. In view of these conditions and the prognosis for restrained growth, the economy is unlikely to experience strong demand for labor during the year ahead.

The only potential shadows on this picture are an upsurge in inflation and a significant increase in protectionism. In the absence of such developments, wage increases will be between 3.5 and 4 percent and unemployment between 7 and 7.5 percent in 1987.

The International Economy

Robert D. Hormats

Developments in the world economy next year will have a major impact on growth prospects for the U.S. economy. Virtually all forecasts of higher U.S. growth in 1987 are predicated on the assumption that this country's trade balance will improve considerably. Some improvement is, in fact, likely — a reduction in the U.S. trade deficit of roughly \$30 billion in 1987 compared with 1986. That, however, will be disappointing to those who have placed great store in major improvements as the result of the decline in the dollar and will still leave American trade and current account deficits at well over \$100 billion.

The major part of the improvement in the U.S. trade balance will come as the result of an increase in import prices (up roughly 15 percent in 1986 from 1985, excluding oil) thus expanding domestic marketing opportunities for American-made goods, and a decline in U.S. export prices of nearly 2 percent from 1985, thus improving prospects for sales of U.S. goods not only in Europe and Japan but also, and very importantly, in third country markets.

Unfortunately, however, at least a portion of the competitive benefits of the lower dollar will be offset by slow or only moderate growth in this country's key trading partners. Japan is experiencing difficulty in generating domestic demand sufficient to offset the reduction in profits and exports resulting from the sharp strengthening of the yen. The degree to which the recent cut in Japan's discount rate and announced fiscal stimulus will generate additional growth remains to be seen. But most evidence suggests that they will not be able to prevent an export-led slowdown—to a shade over 2.5 percent growth—in 1987.

Growth in Western Europe appears likely to be somewhat stronger than that of Japan in 1987 assuming continued vigor in the French, German, and Italian economies — all of which have performed well in 1986. The central role of the German economy in Western Europe will focus the limelight on the policies of the Bundesbank (particularly its willingness to cut the discount rate if growth should falter) and of the Federal Government (which appears prepared to move the tax cut now planned for 1988 up to mid-1987). German, French and Italian growth rates all appear headed for the 3-plus percent range. The British economy continues to benefit from considerable liquidity, strong consumer demand, and growing investment — but concerns about an uptick in inflation owing to a rapid

increase in the money supply, the fall in sterling and higher wages cloud the horizon and point to growth of a bit below 3 percent.

Canada appears poised to continue its above 3 percent growth next year despite weak commodity and energy prices,



Robert Hormats

"Capital flows from abroad seem likely to continue."

but these same factors have been offset in part by increases in consumer purchasing power, stabilization of inflation, lower interest rates and the decline of the Canadian dollar relative to Japan and much of Western Europe.

The developing countries present a mixed picture. Growth is likely to remain strong in South Korea and pick up in the currently lagging South East Asian economies; but much of this growth will be export led and thus will be reflected in the still large U.S. trade deficit with such countries. In Latin America, Brazil and Argentina are likely to enjoy strong growth, but most of the rest of the continent will continue to experience poor economic conditions — maintaining its strong emphasis on limiting import demand and boosting exports, particularly to the U.S.

The impact of past currency fluctuations and anticipated changes in foreign demand will be major swing factors in determining the U.S. trade balance next year and thus a significant determinant in the U.S. growth outlook. But there will be structural factors that will slow the benefits to the U.S. economy. First, the U.S. economy has over the years developed a larger marginal propensity to import — particularly consumer goods. Thus we tend to increase imports of foreign goods more rapidly at a given rate of growth now than in the past and reduc-

tions in the dollar's exchange rate do not discourage imports as quickly today as in past years. Second, markets for America's once robust agricultural exports have weakened, because of foreign subsidies and success in approaching self sufficiency by heretofore large markets such as China and India. Third, Latin American demand remains severely constrained by debt-related constraints on imports. Finally, the dollar has declined against only a handful of currencies, and has stayed about even with or risen against the currencies of many, including large U.S. trading partners such as Canada and Korea.

Assuming that U.S. trade and current account imbalances remain large, the build-up of U.S. external debt will continue along with its potentially troubling consequences. Given the depth of the U.S. capital market, the country can clearly absorb large amounts of foreign capital; and investments in the U.S. still account for less than 10 percent of total foreign savings. The issue then is not so much whether foreign exporters will invest in U.S. securities but on what terms. In recent years the positive yield differentials on U.S. bonds and other securities along with a steadily improving inflationary picture and political continuity have attracted capital from abroad even in the face of a falling dollar. But there may well be times when apprehensions about a further dollar decline, an uptick in inflation, or discontinuity of policy in the White House, Congress, Treasury or Fed will cause foreign investors to withhold, if only for a time, their capital flows to the U.S., thereby push-

ing up interest rates in the U.S. and weakening the growth outlook.

Increasingly the U.S. will have to pay attention to the new reality of dependence of its capital market on inflows of foreign funds. The timing of Secretary Baker's agreement with Japanese Finance Minister Miyazawa was important in reassuring Japanese investors that they could buy Treasury bonds in the latest refunding without being excessively concerned about a further decline. In the future, foreign investors are likely to continue to seek reassurance regarding currency stability. And there will be domestic policy implications. The Fed, for example, could find its flexibility to cut interest rates reduced, were the dollar to fall further and in so doing increase inflationary concerns. Likewise, were other countries to grow more rapidly and absorb a larger share of the capital that now must be exported, without a reduction in U.S. domestic borrowing requirements and with the Federal deficit remaining high, U.S. government borrowing could crowd out private sector borrowing in this country.

In the final analysis the international economy appears likely to remain relatively stable in the coming year and flows of capital from abroad seem likely to continue — barring any unforeseen departure from the current courses of policy in the U.S., or suppliers of capital such as Japan and Germany — although uncertainty as to timing and magnitude will continue as well.

The U.S. Trade Deficit Outlook

Eric J. Kruger

All eyes are currently on the U.S. trade deficit. For months, trade flows have hardly seemed to respond at all to the decline of the dollar. Hopes for a contracting trade deficit in response to a declining dollar were unrealistically high. Now, the monthly trade figures, which are often vastly deceptive, have finally shown an improvement over the past two months. Will a third month of good news herald the positive, downward trend in the trade deficit that would make the drain on the U.S. economy a little easier to bear? If the trade deficit, currently about \$170 billion, does decline, this might well contribute to a quickening of U.S. economic growth. The Department of Commerce estimates that the growing scale of the trade deficit, and its pace, reduced real GNP growth by between 0.8 and 1.9 percentage points from 1980 to 1985, and by 2.5 percentage points in the latter part of 1985. This is one relationship that we can expect to work in reverse: Fewer imports and more exports generally lead to solid growth.

Yet there are three problems with this outlook. The first is the real danger that we are perceiving the cause of fewer imports in reverse. The slowdown in the U.S. economy may be becoming at least as important a factor in reducing imports as the lower dollar. Moreover, slowing growth in all but a few

of the United States' major trading partners, notably Japan, may also be dampening exports. (Japan now absorbs 11 percent of U.S. exports, but its purchases from the U.S. fell by 3.6 percent from the second to the third quarter.) The trade



Eric J. Kruger

"In Congress, stronger protectionist initiatives are coming, with retaliation overseas."

deficit could continue to fall, but it may be because imports contract faster than exports. That would not indicate what analysts have been hoping for—a healthy increase in competitiveness and an exchange-rate advantage. Furthermore, it is

hard to tell at this stage whether this kind of improvement in the trade deficit will offset the extremely sluggish U.S. economy, considering the time needed for such an effect to manifest itself.

Second, the Democrats' return to power in Congress will mean stronger protectionist initiatives, with retaliation overseas. Many industries, both basic and high-tech, have seen rival imports continue to grow and their own exports perform poorly. Across-the-board protectionist initiatives may have been allayed by the lower dollar and recent news of a shrinking trade deficit; pressures from specific industries have not.

The third question mark is the impact of U.S. tax reform and protectionism on foreign capital flows. Tax reform is already attracting attention around the world as promising to expand the domestic market through its effect on net disposable income. It also offers to increase the overall after-tax profit rate (relative to that obtainable elsewhere), even with the abatement of benefits on capital investment. The threat of a resurgence in U.S. protectionism for manufacturing will also increase the flow of foreign investment to that industry. This is likely to put renewed pressure on the dollar, if not in 1986,

then in 1987 and 1988, with a dampening effect on U.S. trade prospects.

An increase in foreign investment after tax reform might not have the full multiplier impact on the trade deficit, if at the same time domestic consumption is contracting in those markets. This is because there will be some crowding-out of both foreign and domestic manufacturers. Such a trend is already visible in the automobile industry.

My outlook calls for the trade deficit to reach \$170 billion in 1986, a moderate reduction of that deficit in 1987 to about \$150 billion, the possibility of renewed pressures on the dollar, and the real possibility of protectionist initiatives. Interestingly, in the longer term, U.S. tax reform provisions and foreign capital inflows specifically devoted to manufacturing should yield fewer imports (of final goods) and more U.S.-made and foreign-made competitive exports. The trade deficit may thus shrink, not for the reasons we may have expected, but because demand in the U.S. and in several of its trading partners is contracting. And it may continue to shrink more from tax reform and protectionism than for any concerted policy action on the dollar.

Consumption and Housing

Roger E. Brinner

The latest round of automobile financing incentives was an enormous hit with both consumers and auto dealers. Retail sales soared in September and what otherwise would have been an unremarkable quarter for consumer spending became the strongest performance since early 1983.

The 7.2 percent third-quarter gain in real spending is unsustainable, however. Automobile financing pushed consumer installment debt to 19.6 percent of income, and the surge in consumption pushed the saving rate below 2 percent for the first time on record. Disposable income must now catch up with spending and debt. Since few signs point to any major gains in income before the first phase of tax reform in January, even non-automotive consumer spending is unlikely to register any significant advance between now and the end of the year.

The impressive consumer spending gains recorded thus far in 1986 vastly overstate the strength of the underlying market fundamentals. Plunging energy prices, generous auto financing terms, and surging stock prices all played to the consumers' advantage, but neither the general economy nor the consumer sector can count on a repeat of these favorable events.

A review of the major determinants of consumer spending suggests that although consumption growth will lag behind that of the general economy, it is unlikely to induce a major downturn. With only modest improvement in unemployment and unchanged average weekly hours, an expected increase of 2 percent in total employment and a 3.4 percent rise in hourly earnings will keep income growth near 6 percent for the next

three years. Disposable income will, however, get a boost from tax reform, which shifts \$120 billion in taxes from consumers to business. Inflation will run close to 4 percent, however, so that even with the personal tax cut, real income growth will be hard-pressed to exceed 2 percent during the next three years.



Roger E. Brinner

"Spending growth will slow throughout the year."

While before-tax interest rates will continue to fall, the phase-out of the deduction of interest on consumer loans and lower marginal tax rates will tend to increase both the consumers' after-tax cost of debt and the return on financial assets. Thus, net consumer debt acquisition will slow throughout the forecast period.

The sharp rise in stock prices during late 1985 and early 1986 raised household assets faster than liabilities, despite the continued runup in consumer debt. Over the next three years,

Real Personal Consumption Expenditures

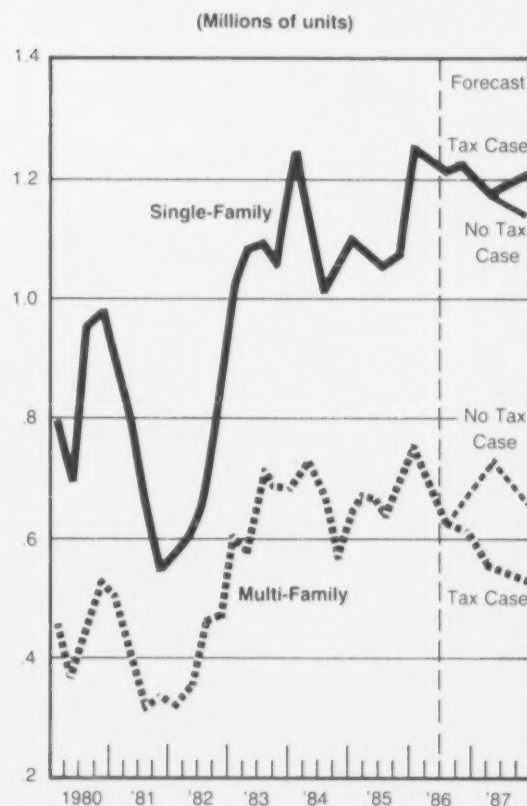
	1985 Actual	1986 Est.	1987 Forecast
Total Personal Consumption	3.5	3.9	2.2
Personal Consumption except Autos and Parts	3.2	4.0	2.2
Durable Goods	7.8	5.5	2.1
Autos & Parts	7.3	2.4	1.8
Furniture & Appliances	8.3	9.7	2.0
Other Durable Goods	8.3	4.8	3.4
Nondurable Goods	1.6	3.7	1.3
Food & Beverages	2.2	1.8	0.7
Clothing & Shoes	2.3	7.1	2.5
Gasoline & Oil	0.4	8.3	2.0
Fuel Oil & Coal	-8.7	7.7	0.9
Other Nondurable Goods	1.1	2.5	1.3
Services	3.7	3.5	2.9
Housing	2.6	2.5	2.8
Household Operation	1.9	0.1	3.6
Electricity	5.1	-1.5	6.3
Natural Gas	1.6	-1.7	2.9
Other	-0.2	1.9	1.9
Transportation	6.7	5.5	6.5
Medical	3.0	3.5	3.2
Other Services	5.3	5.6	1.4
Real Consumption	64.8	65.6	65.4
As Percent of Real GNP			
Per Capita (\$)	9709	9993	10117
Saving Rate (NIPA Basis, %)	5.1	7	4.1
Retail Sales (Billion \$)	1372.5	1439.3	
Percent Change	6.4	4.9	
Real Disposable Income (%Ch)	2.3	3.2	2.1
Civilian Unemployment Rate (%)	7.2	7.0	6.8
Consumer Sentiment Index (1966/1=100.0)	93.2	94.2	92.9
Real Household Financial Assets (%Ch)	13.0	9.1	3.8
Installment Credit Outstanding (%Ch)	18.8	13.7	7.5
Credit Outstanding as % Disp. Income	17.8	19.3	19.6

however, real household net worth will grow only 1 percent annually and thus provide little support for consumption.

Falling energy prices and rising stock prices pushed the University of Michigan's Index of Consumer Sentiment to 99.3 early this year, its highest value in two years. While this index was down to 91.9 by September, consumers remain unusually optimistic for this stage of the business cycle. Attitudes will continue to drift lower during the remainder of this year before modest disposable income growth and a slowly improving unemployment rate early next year reverse the tide.

Real consumer expenditures are expected to decline at an annual rate of 3.9 percent during the fourth quarter as spending for motor vehicles and parts drops from its third-quarter peak. The impending cut in personal tax rates will then raise real disposable income 4.8 percent in the first quarter of 1987,

Impact of Tax Reform on Housing Starts



fueling a minor rebound in consumer spending. With lackluster income growth thereafter, spending growth slows throughout the year. On a fourth-quarter over fourth-quarter basis, real consumer spending rises 3.2 percent in 1986, but the gain slows to 2.6 percent in 1987. (See table for detailed forecast.)

Housing

Having fallen in four of the past five months, housing starts have finally dropped below what the market can absorb. The current 1.68 million unit annual rate is expected to improve in the coming months, bringing the average for the next four quarters up to 1.73 million units. As mortgage rates settle near 10 percent, single-family starts should remain between 1.15 and 1.20 million units (annual rate) through 1988.

Multi-family starts, in contrast, would decline by 250,000 units from their peak in the first quarter of 1986 to the fourth quarter of 1988 as the market absorbs excess capacity and responds to the new tax laws (see chart). Overall, new residential construction should slide from 1.86 million units this year to an average 1.69 million units in 1987 and 1988.

Capital Goods and Inventories

Bruce R. Lippke

The economy remains on a slow but steady expansion path that seems likely to outlast any that even the oldest of us have experienced. Plant and equipment spending normally follows general economic activity with only a short lag and therefore should be experiencing a similar steady-but-slow growth path.

This recovery, however, is still complicated by dramatic restructuring. In this year's second quarter, although real GNP remained at 2.6% growth, real nonresidential investment dropped off suddenly—to 1% below the level a year earlier. But this aggregate statistic only partially reveals the turmoil affecting business planning.

In 1985 overall business investment climbed to 13 percent of GNP, compared to under 12 percent at earlier cyclical peaks. But this time the consumption share also rose to 65 percent compared to 63 percent at prior peaks. The mathematics of our twin trade and federal deficits are indeed charming, as we can invest in the future and consume even more simultaneously, of course paying with IOU's to the foreigners as we use their goods and capital instead of our own. But those problems plague only the longer term forecaster.

The early 1986 air pocket that hit capital spending was primarily triggered by the drop in oil prices. The resulting cash constraints for energy investors produced a 40 percent decline in petroleum-related investment. Then the added new dimension of tax reform comes along, with the effect of imposing a reduction in cash flow that restricts the cash available for investment by many firms. This negative development has replaced the oil-cost savings that otherwise would have been neutral to positive for investment by energy-using industries over the longer term. Thus, the decline in investment, although triggered by the petroleum sector price collapse, has been solidified by the tax reform impact. The distributional effects are wide, with some sectors losing from both the oil price collapse and tax reform and others gaining from both.

It is plausible, however, to conclude that most or all the negatives for business investment from both the oil price decline and tax reform are already behind us. This is easy to imagine for the energy sector in view of the very sharp decline that took place in mid-1986. In addition, it seems likely that the enormous shifts in wealth caused by tax reform were discounted well before passage of the legislation. Furthermore, anecdotal evidence also suggests that the investment decline is mostly over and there will be increases in late 1986, strengthening in 1987.

• *Oil related:* U.S. drilling-rig activity bottomed out in the summer and will increase by 20 percent if crude prices move up from \$14 to \$18. New orders are again being placed for oil and gas casings and other pipeline stock, after what has been called a zero order year.



Bruce R. Lippke
"Difficult to write a recession scenario."

• *Office equipment:* New orders for office equipment and computers have rebounded from their early 1986 collapse and in real dollars are back above a 15 percent trend growth line. Nominal growth of 10 percent and real growth of 20 percent is plausible for 1987.

• *Auto machinery related:* Lower gasoline prices are boosting truck sales. Auto plant modernization is doing better, spurred on by the Japanese-production-process revolution in the U.S. Power tool technology has spread from autos to nearly every business. Equipment orders from overseas are being received again. Commercial airplane books are strong.

• *Construction:* Power distribution equipment is responding to strong residential demand. Shopping-center growth will continue as one element of strength in the otherwise disastrous commercial building sector.

• *Defense related:* While defense contractors are being hit by both a slowdown in defense spending and tax reform, so far at least it looks like they will fall back to a normal contribution to spending growth rather than becoming a big negative quickly.

Inventories

In theory, we should expect to see stable inventory growth flowing from our stable final sales trend. Actually, the change in inventory investment exceeded sales in 1984, as a catch-up from the 1982 runoff, and have fallen short of the sustained sales rate in 1985 and 1986. This has produced record low inventory-to-sales ratios. In 1987 inventories should contribute to aggregate growth even though managers are working harder than one would expect (given that interest rates are down and final sales growing) to keep inventories under control.

Against that backdrop there are the inventory anomalies, such as the sharp rundown of auto inventories in September—perhaps \$22 billion at annual rates—with most of it being restored by November. Another is the oil inventory mystery. Imports are high and prices low, with OPEC production running at a considerable surplus. But the math can't be easily balanced, as the inventories are not to be found. Some of the

U.S. consumption increase may actually represent an increase in user inventories.

Summary

Business investment will decline a modest 1 percent in 1986 and recover by at least 1 percent in 1987. The anecdotal evidence seems stronger than our model-driven forecast, which we could easily decide to strengthen after further review. In inventories, there is no risk of a major run-off and, in fact, there is room for some increase, since market-share battles are typically very tough in a slow but growing market.

While this business cycle expansion is on borrowed time compared to history, it has been slow enough worldwide that it lacks any of the characteristics of overheating that produce recessions. The capital spending and inventory prospects described here make it difficult to write a recession scenario for 1987 or 1988.

Credit Markets

Robert G. Dederick

An old economic maxim tells us that anyone bold enough to accept an offer to forecast the outlook for interest rates, should be asked to return the invitation immediately. He obviously is not smart enough to be trusted with the job.

Regretfully, that sage observation is even more true today than when first articulated by Adam Smith—or was it Groucho Marx? A look at just some of the determinants of interest rates indicates the magnitude of the forecasting problem.

- *The business outlook is uncertain.* With both pluses and minuses at work (in the latter case including, for the record, a less easy fiscal policy), the most prudent forecast—the one least likely to leave the perpetrator badly exposed to error—seems to call for economic growth in the 3 percent neighborhood over the course of 1987. But from this razor's edge pace, a deviation of only one percentage point either way would have markedly different interest rate implications—far different than if the presumed central tendency were, say, 5 percent or 1 percent. And the chances of such deviations occurring are quite high, given the key role that the essentially unpredictable trade balance is asked to play in the forecast. To make matters worse, even if the 3 percent estimate turns out to be correct, there is this little question to consider: Will such a feat be accomplished without help or will it require *lower* interest rates? —or, less likely, will it occur in spite of *higher* interest rates?

- *Market attitudes toward inflation prospects are uncertain.* It is hard enough to predict the inflation rate, but to predict what the market will be predicting for the inflation rate is a task best left to the late Mr. Keynes. Will marketeers be satisfied that inflation is “under control”—as was the case early

this year, when oil prices were declining—or will they be worried that an outbreak lies ahead—as has been true more recently, when attention has been directed to the price pressures destined to emanate from the “inevitable” reduction of the



Robert G. Dederick

“One more window of opportunity for short rates.”

trade deficit (and the “inevitable” further fall in the dollar required to bring about this reduction)?

- *The impact of tax reform is uncertain.* We can be confident that anything as far reaching as the 1986 tax reform has implications for interest rates—both directly and via its impact on the strength of the economy, and also through both its macro and its micro features. But we cannot be confident we know what these implications really are. By the time we achieve the required threshold of knowledge, chances are that the effects already will have been felt. Indeed, some of them probably have been felt by now.

• *Monetary policy prospects are uncertain.* Ignorance of prospective monetary policy is something we accept as a fact of life—it goes with the forecaster's territory. But this ignorance is especially pronounced when we consider (a) the changed makeup of the (increasingly Reaganized but otherwise diverse) Federal Reserve Board membership, (b) the manifold goals (Satisfactory growth, inflation control, orderly foreign exchange markets, financial stability) that the team is trying to achieve in today's ambiguous (and financially fragile) world, and (c) the variegated indicators to which the members look for guidance (including, but not confined to, commodity prices, the dollar exchange rate, several monetary aggregates, the shape of the yield curve, and interest rates across the sea). And the fact that Chairman Volcker's term is scheduled to expire next August adds further spice to the uncertainty.

But, enough! The truth in labeling requirements have been met. Now for the forecast to which they have been—no doubt fruitlessly—attached.

With the economy still not clearly launched on the long-predicted, long-awaited, and long-postponed solid growth trajectory, the odds are that the window of opportunity for

lower short-maturity interest rates will be opened, and utilized, at least one more time. Indeed, it appears to be open at present in consequence of Japan's recent discount rate cut. The monetary policymakers' concern about near-term recession—with its adverse implications for reasonably free trade, the Federal budget deficit, and financial stability here and abroad—will override their concern about later term inflation.

But, with marketeers holding to a more far out view (to be interpreted as one sees fit) the odds also are that longer-maturity rates will fail to take the downward cue and instead will meander along a flatter path—moving to one side or the other in accordance with the latest readings of Japanese investors' intentions, dollar exchange rate prospects, commodity futures prices, and so forth.

Thereafter, short rates are likely to stabilize as the Fed seeks to maintain its anti-inflation credentials, while long rates could well rise somewhat as the market looks ahead to higher short rates down the road (with tax reform having little net macro effect in either area). Assuming, though, that the economy holds close to a 3 percent growth incline, a sharp upswing in bond yields probably will be avoided in 1987. Even in today's brave new financial world, expectations still can carry markets only so far.

The Equity Markets

Robert H. Buckles

From roughly August 1982 to August of this year we have had a phenomenal bull market in U.S. equities. We have gone very far very fast, and signs of distribution and industry rotation began to appear this spring at roughly the same time the long government bond stumbled in its tremendous advance and began waffling. Since most of this bull market—particularly over the past two years—has resulted from multiple expansion rather than an increase in corporate earnings, it seems more than sheer coincidence that the multiple expansion stopped at roughly the same time that the improvement in interest rates ended.

Once again we are at a point where the market is pausing to see whether we are still in a disinflationary, multiple-driven stock market or whether we are shifting to a period when the economy improves. With an economic improvement we would have an increase in corporate earnings to drive the market, although perhaps at the expense of a couple of price earnings multiple points.

Since early summer we have been suggesting that the transition from a multiple-driven to an earnings-driven stock market is not necessarily a smooth one if, indeed, this transition takes place at all. Moreover, there would appear to be more room for a fall if one slips in making this transition, just after we have had an historically strong four-year bull market, than

if there had been more modest gains in the market. Markets where price-earnings multiples have expanded rapidly are less forgiving.

As a consequence, we would continue to look for a correction in the stock market in one of two forms: (a) a sharp cor-



Robert H. Buckles

"Room for a third (and perhaps final?) rally."

rection of 10 percent to 15 percent from its highs of this past summer, or (b) in the form of recurring rotation among industry groups in the market as it seeks to determine whether or not the economy and the economically sensitive stocks will be more attractive or whether the disinflationary scenario is

still in place. My own feeling is that we may have some of both (a) and (b) although I am more inclined towards the (b) or rotation scenario.

Where Are We Going?

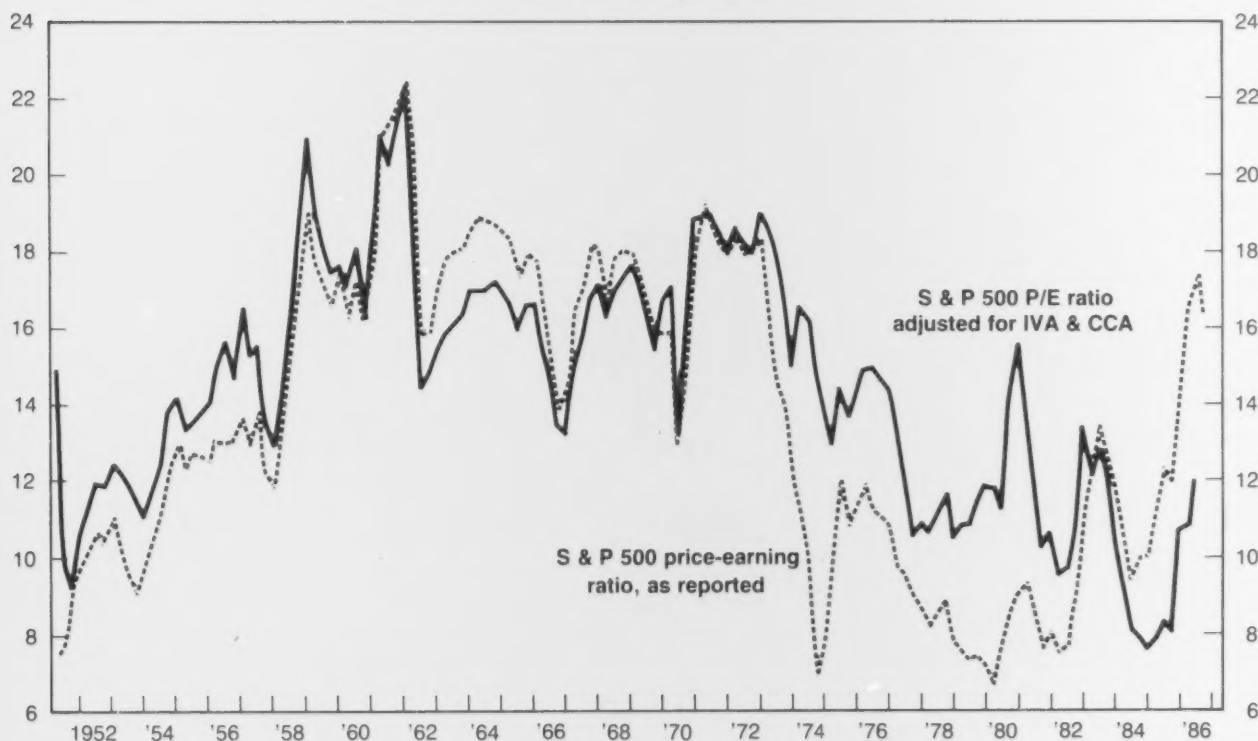
Eventually, I think there is room for a third (and perhaps final?) rally in this historic bull market of the '80s. If one adjusts the sharp advance in the S&P 500 to reflect inflation or adjusts for the improvement in the quality of earnings (as is attempted in the accompanying chart), then the stock market, despite this tremendous advance from the summer of '82 to the summer of '86, still does not appear to be out of line relative to historical standards.

After the current correction that we have discussed in the equity markets has been completed, we then see the possibili-

ty of another upward leg in the equity markets. This might occur if the economy does pick up later on and does so without causing a noticeable increase in inflation. At that time (hopefully during 1987), we might be able to experience both rising earnings and eventually even some further improvement in price-earnings ratios at the same time. This would lead to the final ascent in the stock market and complete the decade of the '80s in grand style.

We could then see that we had unwound the inflationary decade of the 1970s both in the improvement in the quality of earnings as well as in total corporate earnings coupled with an expansion in price-earnings multiples reflecting the lower levels of inflation. The decade would also be the reverse of the 1970s with financial assets once again in the ascendancy, as they were for many years prior to the 70s, and tangible assets having experienced a decade of relative underperformance.

Price-Earning Ratios



**Research
Bulletin**

No. 205

The Conference Board

Marketing Priorities

by Louis A. Wallis

Management Summary

- Improving profitability is marketers' top priority.
- To meet competitive challenges, companies will increasingly emphasize new products, stronger customer linkages, and other alternatives to price competition.
- Many companies' action plans will seek to boost sales force productivity and strengthen their distribution systems.

Marketing Management Research

R4105-29.695(A)

4/87

About This Survey

This survey is based on information provided by 260 members of The Conference Board's Senior Marketing Executives Panel. The participants represent a cross-section of U.S. manufacturers encompassing both industrial and consumer product sectors. While some of the executives, located at a corporate level, reported for their entire companies, a larger number reported on their specific operating units. The panel members hold a variety of managerial titles, the most common being that of vice president of marketing.

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THE NUMBER-ONE MARKETING PRIORITY for manufacturers in the next three years will be maintaining—or, in some cases, regaining—profitability. The latest survey of The Conference Board's Senior Marketing Executives Panel, representing a cross-section of U.S. manufacturers, finds most of the 260 respondents assigning the very highest priority to profitability goals. In pursuing these goals, the marketers will focus their attention on specific competitive challenges in these main areas: developing new products and services; boosting sales and distribution productivity; and strengthening customer relationships.

For a majority, the past three years have been marked by intense price competition, heightened new-product activity, and new inroads of foreign competitors. For a majority, too, marketing has become an ever-growing concern of senior management. Table 1 describes these and other recent changes in key marketing factors cited by the reporting executives. Table 2 describes the relative priorities the marketers say will be given to various marketing challenges confronting their operations over the next three years.

Looking ahead, many managements acknowledge that some current marketing activities, and particularly their costs, will need to be curtailed in the future. Even those enjoying recent market successes confirm a need to regain full fighting trim. As the vice president of an equipment producer puts it: "You get sloppy when times are good. Many changes are really needed. Our customers are much more demanding, but that's good for us. Our products have improved and everyone is better off for it."

Improving Market Competitiveness

The biggest challenges marketers foresee reflect their expectations of a vigorous competitive environment. During the next three years, most marketers will be searching for effective answers and alternatives to price competition. In this regard, many pin their highest hopes on improved offerings to their customers—especially the results of programs aimed at raising product quality.

The task of remaining competitive against both domestic and foreign sellers will be further complicated for the one-third of the total responding who now face a larger number of direct

competitors than they did three years ago. The marketing plans of manufacturers in depressed industries anticipate a scramble for shares of existing business. Not all companies will provoke head-on fights in their markets, if these can be avoided. An electronic components company, for one, intends to develop "nonconfrontational market strategies" with respect to its adversaries, large Japanese and domestic manufacturers.

In some cases, a lack of solid marketing information hampers competitive response. A substantial number of firms will be working to improve the quality of their marketing-information and competitive-intelligence systems. Among those that already benefit from such action is a rubber company. According to its chief marketing executive: "The combination of solid market intelligence and good strategic planning has enabled the growth of our business in the areas we have identified for growth." Similarly, a manufacturer of scientific instruments attributes a 15 point gain in market share to better identification of the firm's customers by market segment.

Fundamental changes in the character of the competition facing some manufacturers pose special threats in the period immediately ahead. For example, one company has traditionally manufactured parts for assembly into complete products by its customers. Now the competitive offerings of foreign suppliers embody not just the parts themselves, but entire product assemblies or large subassemblies. This may eventually force the U.S. producer to take the costly step of forward integration in order to remain competitive.

The marketing vice president of a consumer appliance company notes the growing power of domestic retail chains, which not only forces readjustments by their suppliers but often renders traditional marketing practices uneconomical. In selling to large U.S. retailers, his company competes against Far Eastern manufacturers that have no marketing organizations and few marketing expenses in the United States, since they maintain no stateside inventories or receivables. With a selling structure that is costly by comparison, the U.S. company was compelled to offer unattractive prices to its retailer customers. Attacking the problem from the production side, the manufacturer has begun sourcing components—and even complete products—overseas, thus regaining sufficient cost advantage to support more adequate margins. The company is also de-

veloping new products and product variations to offset temptations for its retail-chain customers to rely on offshore suppliers.

A few managements are resorting to outside help in their attempts to remain competitive. With the assistance of consultants, one capital equipment manufacturer has managed to reduce its manufacturing costs by 35 percent and thereby to maintain leadership in its field.

Occasionally, manufacturers are planning—or have already undertaken—a major restructuring of their marketing operations in preparation for future marketing wars. To take better advantage of its global strength, one firm restructured its product manager system, better enabling it to counter competitive moves worldwide. Another, in preparation for a substantial reorganization, retrained 400 managers in a new program designed to help them to identify critical competitive situations and to rethink their marketing missions.

Developing New Products and Services

Generating new-product ideas is another high-priority mission. For most companies, this follows a period of increased

new-product introductions and greater dependence on new products. Among others, a food company has already installed “a systematic new-product process that encourages creativity and risk taking, while assessing which new-product opportunities to pursue.” A commonly described search is for product niches offering greater market leverage, as well as for new-product entries with demonstrable advantages—for example, cost-effectiveness—to the customer.

The “new” in new products is being redefined in many cases. New just for the sake of newness is no longer enough. Instead, managements are seeking a more precise targeting of new-product programs. Although four out of five marketing operations in the survey increased the number of their product lines during the last three years, several now propose what one executive describes as “intense concentration on core products, rather than diffusion through diversification.” Others, like a producer of industrial components, will place heaviest emphasis on “demonstrable product differences.”

Two different approaches to stimulating new-product advances illustrate the range of methods, from dependence on technical creativity to the application of straightforward mar-

Table 1: Changes in Key Marketing Factors in Past Three Years¹

Key marketing factors	Percent of 260 executives reporting ²		
	Increase	Decrease	No change
Intensity of price competition	83	0	17
Senior management concern for marketing	66	3	31
New product introductions	59	5	36
Impact of foreign competition	56	2	42
 New markets—internally generated	50	2	49
Dependence on new products	49	5	46
Number of line extensions	41	6	54
Number of product lines	40	12	49
 Intensity of nonprice competition	37	6	57
Number of direct competitors	36	11	53
Number of items within product lines	35	11	53
Support for dealers and distributors	35	8	57
 Markets entered by acquisition	30	2	69
Advertising and sales promotion costs as percent of total marketing costs	29	22	50
Marketing costs as percent of sales	27	16	57
Company's sales in foreign markets	19	13	68
 Number of distribution channels	17	7	76
Dependence on direct sales	17	9	75
Markets relinquished by divestiture	6	7	88

¹Reported changes in factors listed on questionnaire.

²Rows may not total 100% because of rounding.

Table 2: Marketing Priorities for Next Three Years¹

Marketing priorities	Percent of 260 executives reporting ²				
	Highest priority		Lowest priority		
Profitability	68	25	6	1	0
Alternatives to price competition	54	27	15	3	1
Product quality	51	26	16	5	1
Sales force's productivity	49	41	7	2	0
Better communication with customers	45	39	15	1	0
Price competition	40	36	16	6	2
Generating new-product ideas	39	34	19	5	2
Emphasis on long-term strategy	35	38	20	7	1
National account programs	29	30	25	10	6
Adding new products or services	28	42	18	8	4
Exploiting new market segments	28	43	21	6	2
Strengthening distribution channels	27	40	21	8	4
Training and development	27	36	27	9	1
Better marketing information systems	25	46	23	5	1
Marketing cost-control	22	37	34	6	0
Competitive intelligence	21	43	28	7	2
Expand or diversify by acquisitions	20	27	18	18	18
Better internal communications	19	44	28	8	2
Technical and service support	17	36	31	13	3
Support for dealers/distributors	16	32	25	17	10
Management development	16	36	31	14	3
Reducing new-product risks	16	25	39	13	8
Emphasis on short-term tactics	15	36	34	14	1
Increasing foreign market sales	15	31	18	15	21
New distribution channels	14	19	26	25	16
Reorganizing sales force	14	27	25	22	12
Line extensions	13	35	27	20	6
Improving physical distribution	13	26	31	18	11
Reorganizing marketing staff	11	28	30	20	11
Reducing dependence on market segments	10	27	40	14	9
Market measurement and research	10	28	38	18	5
Sales promotion and merchandising	10	24	37	22	6
Increasing reliance on computers	8	40	33	14	5
Advertising support	8	24	41	20	7
Deleting products or services	7	21	37	22	12
Telemarketing capabilities	7	20	27	21	25

¹ Executives reported the relative priority of each item on a five-point scale, from highest to lowest.

² Rows may not total 100% because of rounding.

keting expertise! An R&D breakthrough allowed one electrical equipment company to manufacture a basic component of its products in a way that cuts costs and improves performance. With further development of a new process to produce the new material and field tests confirming performance superiorities as well, the company plans to reap a competitive advantage. By paying attention to basic marketing skills such as marketing research and market testing, a producer of consumer textile products netted a significant sales increase by simply revamping its product lines and offering several new products.

In some cases, new-product success is resulting from early involvement of customers in the product-design process. One company, following this approach, developed a new component providing benefits of superior performance, lighter weight, and lower cost. The supplier's application engineers now meet regularly with customer counterparts to discuss upcoming opportunities for new products.

Some marketers are addressing their need for speeded-up and better targeted R&D efforts. "Because of the shortened life expectancy of our products," reports the vice president of one industrial products manufacturer, "R&D must have replacements sooner. Commercialization must be done more quickly." With this in mind, some firms are taking pains to strengthen the linkage between marketing and R&D. In the case of a chemical producer, for example: "All segments of our company are now market driven. Production and R&D are no longer on the sidelines. More application work is done in our labs."

Sales and Distribution Productivity

Managements in most responding companies will employ a variety of means in the next three years to ensure greater productivity of their sales forces. For example, national account programs, aimed at serving a company's most important customers, will rate high priority. Most manufacturers will also be working to strengthen existing distribution channels, rather than adding new ones.

A maker of industrial equipment, isolated from the ultimate users of its products by intervening distribution channels, is one of several firms taking steps to get better information from the field for planning its programs. Its marketing director says: "In taking a more active interest in distribution to the end user, whether industrial, retail or contractor, we become more aware of how our products are used. This leads to a broadening of our product lines."

Apart from other actions contemplated (or in progress) for improving their selling capability, over 10 percent of the surveyed manufacturers have recently taken the step of reorganizing their sales organizations in some way. Their objectives and solutions differ widely. Some have moved toward greater consolidation of their forces, while others were shifting in the opposite direction. Recent periods of depressed sales have led a few companies to reassign some of their sales personnel to product-service positions.

¹For a reporting on how the commercial development function in some companies contributes to new product development, see Michael G. Duerr, *The Commercial Development of New Products*, The Conference Board, Report No. 890.

Strengthening Customer Relationships

While one of the executives suggests that customer loyalty may be a remnant of former times, the hope of generating such loyalty—or, even more often, of becoming an indispensable supplier—is a widespread, high-priority goal among the reporting manufacturers.

A few have recently gone to exceptional lengths to keep valued customers happy. A chemical company's vice president of marketing reports: "One of our good customers needed a product we didn't make, formerly supplied by a competitor that dropped the line. We set up a manufacturing facility to make that product because we were dedicated to that customer. We have to take the bad with the good in this industry."

Other manufacturers, however, are reaching the profitable limits of certain service offerings. One, for example, has been incurring high costs when performing pre-sale development and applications work for its prospective customers. A spokesman reports that, unfortunately, it is difficult to get paid for that work. On occasion, a prospect benefitting from this consultative help has then turned to a competing supplier to purchase a similar product at a lower price. Such experiences are causing management's reconsideration of this company's consulting service program.

A changing customer base is jeopardizing future market prospects for still other firms. Says one executive: "We are approaching a point where there will be no small customers and no small competitors. Until that process is completed, we must be prepared to endure erratic market behavior by customers and competitors alike struggling in a survival mode."

A group vice president of another industrial products company voices a common concern about "the continued retrenchment of U.S. industry. The consolidation that will take place will put extreme pressure on suppliers. The resulting overcapacity, price pressure, and elimination of outlets will be difficult to deal with."

Most executives, however, remain upbeat in viewing the future, with their optimism often based in part on their companies' plans for developing closer, more productive relationships with their customers. A typical explanation is that of an equipment company's marketing vice president: "We are looking for relationships, not transactions." Other executives refer variously to hopes of becoming a "team player with the customer" or of building a "customer partnership to parallel component and system development." The challenge, in the words of yet another, is "meeting the quality, price and delivery targets of customers who want world class suppliers."

"Value added" is said to be a key ingredient of numerous company plans. In an industry facing stagnant growth, a manufacturer of textile dyes selected certain target segments potentially receptive to a value-added appeal—that is, segments sensitive to the advantages of dealing with a supplier whose products can minimize the number of "seconds" the customer may be forced to sell at reduced or distress prices. With a "partners in profit" mission, the manufacturer has successfully begun to promote use of high-quality dyes which, although they cost more, yield high-quality production runs and protect profit margins.

Most marketers claim already to be listening more closely to what their customers say. In several cases, applications engineers, as well as members of the regular sales team, are "hitting the road" to learn first-hand about customers' needs. The key to these and, indeed, all marketing efforts, several marketers remind, is the seller's ability to perceive the buyer's view. The

marketing director of one industrial products company sums up its challenge this way: "Our customers are being presented with an incredible amount of environmental and legal challenges to their historic ways of doing business. We must analyze their situation and provide products and services that keep them on the leading edge of their respective markets."

Summer Youth Employment: 1987 Edition

by Wesley Etheridge and
Nathan Weber

Management Summary

- **Slight Increase in Placements**

Public-Private Partnerships in 34 U.S. cities placed 151,600 youths in jobs during the Summer of 1986—an increase of only 1.2 percent over the previous summer.

Program administrators expect to place most of this summer's youths primarily in community improvement and maintenance jobs. Very few expect to place a majority of youths in fast-food establishments.

- **Dropout Rate**

The school dropout rate is pinpointed as a leading cause of persistently high youth unemployment.

Corporate Relations Program

About This Research

With the 1987 edition, the annual Conference Board survey of summer youth employment has been expanded from 14 to 34 major U.S. cities. This edition also uses data from each city's primary youth employment program, resulting in a more comprehensive picture of summer jobs in each locale. Most programs that report to the Board are administered by official Private Industry Councils; in a few instances they are directed by other public-private partnerships.

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Summer youth employment programs in 34 major cities throughout the United States placed 150,002 youths in jobs in 1986, an increase of 1,183, or 1.2 percent, over the Summer of 1985. (See Tables 1 and 2.) The programs are administered by Private Industry Councils or other public-private partnerships.

The 17 cities reporting increases over the previous summer indicated that the gains were accomplished through additional private-sector involvement, the availability of more jobs, earlier recruitment efforts, and increased funding from various sources in their areas. On the other hand, cities reporting decreases in the number of placements blamed federal grant reductions, the transfer of job-placement funds to assessment and remedial education programs, and the lack of young candidates possessing job skills sought by employers.

Most administrators of the employment programs predict an equal or better performance for the Summer of 1987: Of the 34 cities that responded to the annual Conference Board survey, 24 expect to place more or about the same number of youths as they did in 1986.

Seven respondents expect to place more youths in 1987. Their predictions are based on the extension of the Targeted Jobs Tax Credit (TJTC) (which gives employers a tax credit for a percentage of wages paid to teenagers hired during summer months), increased placement goals, and planned improvements in such areas as recruitment and private sector participation. Those who expect to place the same number of youths—17 cities—cite similar funding levels and job offers by companies.

Among the 10 respondents who predict a decline in the number of placements in 1987, the majority cited federal fund reductions and remedial education training costs that will not be covered by the government. Both factors are expected to reduce the money normally available for salary and administration costs.

Private Sector Contributions

Private industry donated \$2,941,509 in cash, and at least \$3,571,116 in in-kind contributions to the 34 cities during the Summer of 1986.

According to the youth employment program administrators, in-kind contributions included "loaned" executives, donated television, radio, newspaper and magazine advertisements, and printing services.

Youth Unemployment

The unemployment rate for young people during the Summer of 1986 was higher than the rate for the preceding year; for the population as a whole, however, unemployment decreased. (See Table 3.) In August of 1986, 14.3 percent of all teenagers and 35.3 percent of all black teenagers went jobless, while the national unemployment level last summer stood at 6.7 percent.¹

Despite a decrease in the U.S. youth population and in the youth labor force, and despite evidence that this trend will continue, youth unemployment is expected to increase through the

Table 1: Summer Job Placements: 1985 and 1986

	1986	1985
Albuquerque	1,070	1,208
Baltimore	4,012	4,004
Boston	2,347	2,320
Bridgeport	1,599	1,608
Buffalo	1,225	1,400
Charlotte	1,134	905
Chicago	25,835	23,000
Cleveland	7,103	8,400
Columbus, GA	1,213	1,346
Columbia, SC	155	154
Dallas	2,412	1,950
Denver	1,229	1,230
Detroit	9,850	9,500
Indianapolis	2,973	3,122
Jackson	590	629
Jacksonville	1,146	1,047
Jersey City	1,901	1,810
Little Rock	399	780
Los Angeles County	9,500	10,897
Louisville	2,355	2,000
Milwaukee	2,996	2,583
Minneapolis	1,358	1,714
New York	36,239	31,584
Oakland	2,124	2,020
Oklahoma City	550	691
Omaha	134 ¹	358
Philadelphia	18,083	19,739
Pittsburgh	2,389	2,309
Portland	2,210	1,915
Richmond	910	820
Salt Lake City	1,188	1,059
San Francisco	1,044	1,389
Seattle	2,865	3,503
Tucson	864	1,145

¹The comparatively low number of youths placed in Omaha in 1986 reflects the results of new procedures that required businesses to pay 35 percent of the young peoples' wages. In the past, contributions from larger corporations funded both the program's operating costs and youth wages.

end of the century, according to the National Alliance of Business (NAB). NAB based its projection on "continued ineffective vocational counseling and job placement and lack of basic literacy skills of youth, particularly minorities."²

The study pinpointed an increasing school dropout rate as the leading cause of the youth unemployment trend. In turn, the NAB offered two factors that account for the rising number of dropouts—which is estimated by the NAB at one million youths each year. (However, the actual number as well as the methods of measuring it are disputed by experts.) The first factor is a soaring increase in teenage pregnancies which, NAB estimates, will prevent half-a-million young mothers from ever

¹Source: Interview with U.S. Bureau of Labor Statistics official.

²National Alliance of Business, *Employment Policies: Looking to the Year 2000*, 1986, p. 2.

Table 2: 1986 Placements in Private and Public-Service Sectors

	Private Sector	Public Service
Albuquerque	65	1,020
Baltimore	2,883	1,129
Boston	2,276	71
Bridgeport	78	1,521
Buffalo	0	1,225
Charlotte	307	827
Chicago	1,750	24,085
Cleveland	0	7,103
Columbus, GA	0	1,213
Columbia, SC	141	14
Dallas	270	2,142
Denver	0	1,229
Detroit	0	9,850
Indianapolis	897	2,076
Jackson	0	590
Jacksonville	1,146	0
Jersey City	0	1,901
Little Rock	46	353
Los Angeles County	0	1,901
Louisville	55	2,300
Milwaukee	1,195	1,801
Minneapolis	0	1,358
New York	36,239	0
Oakland	60	2,085
Oklahoma City	17	533
Omaha	134	0
Philadelphia	4,652	13,431
Pittsburgh	13	2,376
Portland	160	2,050
Richmond	660	250
Salt Lake City	110	1,078
San Francisco	961	83
Seattle	400	2,465
Tucson	13	851

Table 3: Seasonally Adjusted Summer Unemployment Rates: August 1985 and 1986

	August 1985	August 1986
Civilians	6.9	6.7
Teenagers (16-19 years old)	15.1	15.3
Black teenagers (16-19 years old)	32.4	35.3

Source: U.S. Bureau of Labor Statistics.

completing school. The second factor is a lack of attention given to potential dropouts by school authorities.

The dropout increase is particularly distressful because many experts acknowledge that more and more jobs will require not only basic reading, writing, and math skills, but problem-solving, analytic, and communication skills as well.

4 The Conference Board Research Bulletin

Job Training Partnership Act

Another factor in youth unemployment may be problems inherent in the Job Training Partnership Act (JTPA), the major federal program addressing the issue. The Act, which provides states with funds for year-round training and for summer youth jobs, is reported to suffer from several programmatic deficiencies, according to some vocational experts.

Stressing low-cost, short-term employment and training services, and combining the efforts of the public and private sectors to serve economically disadvantaged youth, JTPA replaced the Comprehensive Employment Training Act (CETA). Unlike its predecessor, it does not place enrollees in jobs created for them, which some observers have called "make-work" positions. JTPA's programs are designed to train people for jobs in the private sector in an unsubsidized capacity.

Critics, however, claim that JTPA is "placement oriented." This, they argue, leads JTPA program directors to seek those people who are easy to train and place, most of whom were likely to obtain jobs on their own in any case. As a consequence, they say, those youths most in need of training and placement are largely ignored.³

Where the Jobs Were; Where they Will Be

Twenty-nine percent of the youths placed by public-private partnerships in The Conference Board's 1986 summer survey found jobs in maintenance; 24 percent were placed in clerical positions; 6 percent in fast-food establishments; and the remaining youths in delivery and other positions. (See Table 4.)

Most respondents to the survey (38 percent) predict that the majority of 1987 summer placements will be in maintenance; 29 percent predict that most recruits will find jobs in community service; and 26 percent see the clerical field as offering the greatest number of jobs. Reversing a summer employment trend, fewer youths are expected to be drawn to fast food establishments in 1987: Only 6 percent of those who responded to the Conference Board survey indicated that they expect to place most of next summer's recruits in fast food employment. (See Table 5.)

Lack of Jobs—Or Lack of Youth?

Evidence of a declining youth population in the United States has led several observers to maintain that jobs for teenagers are going begging. "Suddenly America is running up against serious labor shortages that are crimping many businesses and forcing corporate headhunters to work overtime," according to *Time* magazine.⁴ In a similar analysis, *The Wall Street Journal* reported that the labor shortage will improve employment prospects for young people—since employers will have to hire

³Karen Blumenthal, "Off Target?: Job-Training Effort, Critics Say, Fails Many Who Need Help Most," *The Wall Street Journal*, February 9, 1987.

⁴George Russell, "A Maddening Labor Mismatch," *Time*, April 28, 1986, pp. 48, 49.

Table 4: Where Youths Were Placed in 1986 (Percent of placements)

	Clerical	Fast Food	Delivery	Sales Clerk	Maintenance/ Cleanup	Community Service	Other ¹
Albuquerque	58%	3%	0%	.02%	0%	0%	39%
Baltimore	30	20	2	14	14	0	20
Boston	61	9	0	17	19	15	11
Bridgeport	12	0	0	0	16	72	0
Buffalo	16	4	0	0	67	8	4
Charlotte	.01	13	.01	3	41	0	28
Chicago	28	22	3	13	7	2	25
Cleveland	16	4	0	0	54	2	25
Columbus, GA	20	0	0	0	40	20	20
Columbia, SC	12	25	.01	12	3	4	43
Dallas	28	0	0	0	17	55	0
Denver	33	0	0	0	38	0	29
Detroit	12	0	0	0	75	12	2
Indianapolis	25	8	.01	2	39	2	25
Jackson	34	5	0	0	59	3	0
Jacksonville	27	22	0	5	9	0	37
Jersey City	17	0	0	0	29	28	27
Little Rock	18	0	0	0	49	33	0
Los Angeles County	21	0	0	0	21	58	0
Louisville	13	0	0	0	47	6	35
Milwaukee	12	18	4	7	34	7	16
Minneapolis	26	0	0	0	13	27	34
New York	25	7	7	20	20	3	18
Oakland	37	0	2	0	9	47	5
Oklahoma City	37	2	0	0	29	26	4
Omaha	8	28	11	16	18	.0	18
Philadelphia	32	6	0	16	14	18	10
Pittsburgh	3	0	0	0	41	42	14
Portland	9	0	0	2	20	36	36
Richmond	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Salt Lake City	N/A	N/A	N/A	N/A	N/A	N/A	N/A
San Francisco	44	.02	2	4	19	2	20
Seattle	20	10	0	15	20	25	10
Tucson	38	0	0	2	23	0	37

¹Recreational aides, repairs, tutorial, social services, etc.

even unqualified people and train them—as well as look to other potential sources of labor, such as the elderly and the mentally and physically handicapped.⁵

To explore this issue in the cities surveyed, The Conference Board asked program directors whether the problem in their communities was an insufficient number of youths applying for existing jobs, or a lack of available job opportunities. Twenty of the directors responded that not enough jobs were available. However, their comments indicate that the problem goes beyond an actual scarcity of work. Other factors cited include a lack of jobs providing quality work experience, unattractive salaries in jobs that do exist, and insufficient skills among the youths. The remaining fourteen directors said not enough

youths were available to take advantage of existing job opportunities.

The labor shortage has not hit all areas equally. According to an analysis in *U.S. News and World Report*, severe labor shortages are common in the suburbs of Boston, New York, Atlanta, parts of the Midwest, and California. But in Houston, Dallas, and other cities affected by the collapse in oil prices, jobs are filled quickly.⁶

Legislative Issues

New legislation and administrative developments affecting summer youth employment pertain to the minimum wage and to the targeted jobs tax credit.

⁵Martha Brennigan, "A Shortage of Youths Brings Wide Changes to the Labor Market," *The Wall Street Journal*, September 9, 1986.

⁶Kenneth R. Sheets, "Teen Jobs Go Begging This Summer," *U.S. News and World Report*, July 7, 1986, p. 59.

Table 5: Where Most of 1987's Summer Jobs Will Be

City	Job Category
Albuquerque	Clerical
Baltimore	Clerical
Boston	Clerical
Bridgeport	Community service
Buffalo	Maintenance
Charlotte	Maintenance
Chicago	Community service
Cleveland	Maintenance
Columbus, GA	Maintenance
Columbia, SC	Fast food
Dallas	Community service
Denver	Maintenance
Detroit	Maintenance
Indianapolis	Maintenance
Jackson	Maintenance
Jacksonville	Clerical
Jersey City	Maintenance
Little Rock	Maintenance
Los Angeles County	Community service
Louisville	Maintenance
Milwaukee	Maintenance
Minneapolis	Community service
New York	Clerical
Oakland	Community service
Oklahoma City	Clerical
Omaha	Fast food
Philadelphia	Clerical
Pittsburgh	Community service
Portland	Community service
Richmond	N/A
Salt Lake City	Community service
San Francisco	Clerical
Seattle	Community service
Tucson	Clerical

Minimum Wage Controversy

The effect on youth employment of the minimum wage, currently at \$3.35 an hour, remains in dispute. The Reagan Administration maintains that an increase in the minimum wage, like all wage increases, would lead to inflation. It also maintains that an increase in the minimum wage would force employers to forego hiring, thereby exacerbating the unemployment problem. Administration officials have announced that they will block any efforts to raise the minimum wage.⁷

Labor advocacy groups, in contrast, argue that the "real" minimum wage—adjusted for inflation—is at its lowest level since 1955. The National Council of Employment Policy, a non-profit group, maintains that increases in the cost of living have

⁷Kenneth B. Noble, "Democratic Leaders Say Congress Will Increase the Minimum Wage," *The New York Times*, February 17, 1987, p. L-1.

caused a decline in the wage's purchasing power by 26 percent since 1981, the year it was raised to \$3.35. Concluding, therefore, that the current wage is not a cause of the prevailing high unemployment rates among youths, the Council is seeking an increase.⁸

Legislation to raise the wage to \$4.65 an hour over the next three years was introduced in Congress on March 25 by Senator Edward M. Kennedy (Democrat, Massachusetts) and by Representative August F. Hawkins (Democrat, California.). The increases would reportedly affect the wages of about 10 million workers.

Extension of Targeted Jobs Tax Credit

The Targeted Jobs Tax Credit (TJTC)—which enables employers to receive a tax credit for a percentage of wages paid to youths hired during summer months and to other individuals hired during the year—was renewed on October 22, 1986 and will extend to hirings throughout 1988. However, a reported lack of employer interest in utilizing the credit led a number of states to halt certification soon after the old law expired in December 1985.⁹ Citing the credit as ineffective, the Reagan Administration has opposed it. On the other hand, Senator John Heinze (Republican, Pennsylvania) has introduced legislation to make it permanent. According to Senator Heinze, the credit is underused "because employers can't count on its existence from year to year."¹⁰

Successful Youth Employment Programs

Vocational experts often claim that the most effective youth employment programs are those that combine remedial education with vocational training and employment, especially those that concern poor and undereducated teenagers.

Examples of programs that utilize such elements were reported by the Youth Policy Institute.¹¹ They include the following:

Summer Training and Education Program (STEP)

The Summer Training and Education Program (STEP) is a demonstration project run by Public/Private Ventures Corporation, based in Philadelphia. It enrolls economically disadvantaged teenagers as young as 14 years old and provides employment, job training and remedial education.

Since its inception, STEP has enrolled 1,600 14- and 15-year-olds at five sites. The youths receive minimum wage for working halftime. They also attend classes that emphasize not only

⁸"Real Value of Minimum Wage At Lowest Level Since 1955, Council Says In Calling For Hike," *Daily Labor Report*, March 3, 1986, p. A-7.

⁹"Tax Report," *The Wall Street Journal*, October 29, 1986.

¹⁰"Sen. Heinze Plans to Introduce Bill to Create Permanent Jobs Tax Credit," *Daily Labor Report*, March 6, 1987, p. A-16.

¹¹Darryl Brown, "Promising, Promising: Existing Programs Prove We Can Beat Youth Unemployment," *Youth Policy*, July 1986, pp. 18-19.

job skills, but also "life skills," such as responsible social behavior and decision-making. According to STEP administrators, youths in the program show marked improvements in academic and job skills.

Jobs For America's Graduates (JAG)

Jobs for America's Graduates, begun in 1980, works with high-school seniors who are in danger of failing or dropping out. It provides job training and placement to students who are, for the most part, not prepared to find "decent" jobs on their own after graduation.

JAG's emphasis is on job search and career planning techniques, work attitudes (reported to be poor among newly-hired young workers¹²), basic skills, and the obtaining of a diploma. JAG participants received up to five hours a week of direct contact with staff through seminars, lectures and other learning activities. The program reported a 90% placement rate. However, not all JAG students were identified as the most "at-risk" teens, and only half were from low-income families.

Job Start

Job Start, now operating in 11 cities, is targeted specifically to poor dropouts between ages 16 and 24 who read below the eighth-grade level, are in need of remedial education and employment skills, and who qualify for federal job training. Currently, 650 participants are enrolled in Job Start centers, where long-term training in academic and trade skills is provided.

¹²Leonard Lund and E. Patrick McGuire, *The Role of Business In Precollege Education*. The Conference Board, Research Bulletin No. 160, 1984, p.5-6.

Participants may hold part-time jobs. This program has been compared with the federally operated Job Corps—which has been credited with a 75 percent placement rate—in its ability to reach the hard-core unemployed.

Prescriptions For Improvement

Youth employment program administrators who responded to the Board's survey agree on many of the steps needed to improve summer youth employment prospects. According to the project director in Omaha, for instance, job opportunities for youths would increase "either if public transportation to areas outside of the city was provided, or if more inner-city jobs were created." And, according to the youth employment director in Columbus, South Carolina: "Additional economic development in nonurban areas and a more comprehensive public transportation system would definitely improve youth employment prospects."

The majority of the program directors, however, report that the most effective means of improving youth employment prospects is through more involvement from the private sector, particularly in an era of federal funds cutbacks. The program director in Cleveland commented: "We need to see a much greater commitment from the private sector, other than in fast-food jobs. If the federal government is going to continue to reduce funding, then it is essential that someone take up the slack. We need the expertise and knowledge of the private sector—and more money!" The program administrator in Portland added: "The private sector must see itself as a partner in training youth for employment. Unless this happens, and even if federal funds do not decrease further, we will still be severely limited in the number of youths we can serve."

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Forecasting Public Affairs Priorities: 1987 Edition

by Catherine Morrison

Management Summary

How Do Companies Rank Issues?

The ten most important issues are:

- | | |
|--------------------------|--|
| 1. Tax reform | 6. Protectionism |
| 2. Environmental issues | 7. Technology and economic competitiveness |
| 3. Tort liability reform | 8. Reregulation |
| 4. Health care | 9. Budget deficit |
| 5. Deregulation | 10. South Africa |

Company Commentary on Key Issues

Officers comment frequently on the issue of technology and economic competitiveness, using it as an umbrella to cover fair trade vs. protectionism, regulatory reform, productivity and standard-of-living.

Tax reform continues to concern most corporate officers.

Environmental protection, particularly regarding toxic waste disposal, remains high on the list.

Forecasting Emerging Public Policy Issues

Companies see continuing concern with current issues rather than the emergence of new topics. The issues most likely to be of concern in the next three years are:

- | | |
|-------------------------|--------------------------|
| 1. Tax reform | 4. Deregulation |
| 2. Environmental issues | 5. Tort liability reform |
| 3. Protectionism | |

Corporate Relations Program

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Introduction

Each year The Conference Board polls public affairs officers on how they assess and manage the variety of concerns that come under the rubric of public policy issues, on how concentrations of staff and resources shift over time, and on the anticipated courses of action. The Board's study is not only interested in corporations' concerns about changes in the social, political and economic environment, but also in how firms affect the legislative process and which efforts companies find most effective.

This is the second survey in a continuing series that will allow Conference Board researchers to monitor corporate perceptions on a broad range of issues. The Board effort focuses on those national and international issues that currently, or may in the future, affect the ways in which firms are permitted—or required—to do business.

Recognizing that many firms are profoundly concerned with state and local issues, this study deals with such topics when possible. In most cases, however, detailed accounts of local issues are beyond the scope of this report. Other Conference Board activities and reports address local issues more thoroughly; the majority of issues in this survey involve matters of national public opinion or policy.

Adapting To Change

When corporations are required to streamline their operations—due to mergers, down-sizing or restructuring—the process of identifying and tracking issues often becomes subject to close scrutiny, and its effectiveness is weighed with care.

Corporations make substantial investments in this intelligence-gathering process, and for many reasons. First, corporate managements abhor uncertainty because it renders long-range planning impossible. Most public policy issues seem to involve change and, in order to prepare for change, corporations must have some idea of the dimensions of possible organizational, financial and managerial shifts. An early warning on either changing public attitudes or the emergence of a concern new to the public or lawmakers is of critical importance for executives.

This Conference Board survey focuses not only on which issues concern companies but also on how effective firms are in shaping the legislative agenda (See Exhibit 1). In response to the Board's 1985 survey, public affairs officers said their companies were more often reactive than proactive. In 1986, more companies report that their lobbying efforts have started earlier in the process and, as a result, are more effective. "We have become more concerned with getting out front early on an issue," reports one respondent whose firm is involved in a variety of disparate issues.

How Companies Rate Their Early Warning Abilities

"We can deal with almost anything if we know it's coming, but we spend a good deal of time preparing for 'non-events'.

About This Report

In order to assess how corporate officers define, rank and manage various public policy issues facing their organizations. The Conference Board conducted a mail survey and field interviews during the Summer and Fall of 1986. A list of 1,200 public affairs officers was selected from the 1,000 largest industrial firms and the 200 largest services companies (including finance, transportation, and insurance). Questionnaires were mailed to these companies and 232 usable responses were obtained. Approximately three-quarters of the respondent companies were manufacturing firms and the remainder were service firms from the services sector. Data from these questionnaires constitute the principal source of information for this report. Personal and telephone interviews were conducted with public affairs officers, government affairs officials, and functional executives in other relevant departments of the respondent companies in order to gain additional insights on issues affecting these units' operations.

Because of ongoing legislative activities that alter the status of various issues (for example, tax reform and environmental regulations), and because of the volatility of other issues, this analysis represents a picture of corporate concern at a particular point in time. This is the second survey in this area, and The Conference Board intends to repeat this study at regular intervals, with the first report (1985) serving as a baseline against which shifting attitudes and priorities can be measured.

The survey was initially conducted in response to inquiries from CEOs, public affairs officers, and other senior executives seeking to obtain comparative data on how competitors and other companies of similar size and organization perceive and involve themselves in various public policy issues. Because this report measures both the rank order of the issues (in terms of their importance to the corporation), as well as the degree and type of corporate involvement in them, it should provide a useful response to such questions.

The time spent is worth it to us because of the nature of our business—we can't afford to have a crisis catch us unaware.

"Primarily, our time is spent on issues of immediate concern; secondarily, on contingency plans for a crisis situation. Less time is spent on emerging issues."

—a diversified manufacturing company

Nonetheless, most companies consider themselves well-prepared to deal with public policy issues that are of immediate concern, as well as to identify early-on those issues likely to concern them in the near future. A fifth of those surveyed rate their early-warning systems as "excellent," a percentage similar to the 1985 response. In 1986, ten percent more see their systems as "good" than did in 1985, while only two percent of all respondents believe their companies handle issues identification poorly. (See Table 1.)

The Corporate Tracking Effort

A slight shift in the corporate issues-tracking effort has occurred between 1985 and 1986. In 1985, 53 percent reported that they did not have a "formal" issues-tracking effort. In

Exhibit 1: Issues Management: a Process for Impact

(A manufacturing company's summary of the firm's issues management process.)

Government Relations means:

- Corporate Communications with Government
- Issues Management
- Political Action Committee

Government Relations Goals and Objectives:

The overall goals of the government relations department are to develop an effective and proactive program that is fully integrated with business strategies and operations, and to utilize effectively staff, budget and outside resources to expand and improve our issues management and the political action committee (PAC).

Legislative Objectives:

Identify legislative objectives that require active support. Specific objectives are identified for each session of Congress and for the state legislative sessions. In arriving at these legislative objectives, the following criteria are used:

- (1) How significant is the impact on the company?
- (2) Can the company affect the development of the issue?
- (3) Does the issue complement the overall business-and government-relations strategy?
- (4) Are resources available for the issue?

Operational Objectives:

Discuss potential issue objectives with the relevant operations or corporate staff so as to insure that the issue fits the criteria for action.

Issue Categories:

Each identified issue is placed into one of three levels of priority so that company resources and time are used most effectively.

First Priority:

Issue of primary concern to the company; issue meets the four criteria for priority treatment.

Second Priority:

Issues are monitored, but less staff time is anticipated on them. Company involvement occurs only if the status of the issue changes significantly.

Issues Management:

- Surveillance/forecasting/identifying/tracking
- Evaluating/prioritizing
- Assigning responsibility
- Structure
- Position and strategy development
- Implementation
- Measurement/feedback.

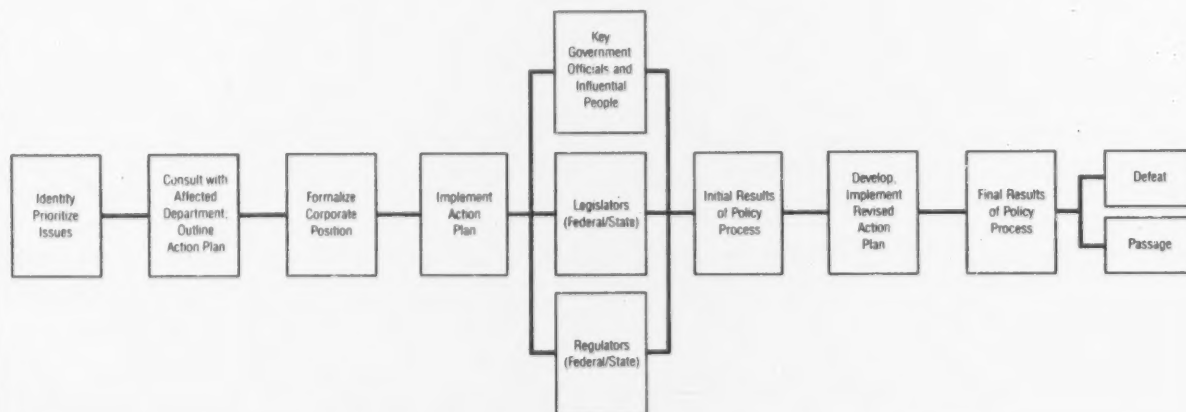


Table 1: Companies' Evaluation of Their Ability to Identify Key Public Policy Issues

Evaluation Rating	1986	1985
	Percent of Companies (N=223)	Percent of Companies (N=252)
Excellent	20.0%	21.0%
Good	55.0	45.0
Average	23.0	31.0
Poor	2.0	3.0
Total	100.0%	100.0%

1986, this group of respondents reflects a minority voice of 49 percent, with a 51-percent majority designating specific individuals or groups as now having responsibility for the issues identification and management function.

As in 1985, nine out of ten companies rely on internal staff for identification and tracking activities. Only 5 percent contract their work to consultants, although almost all have subscribed to outside polls and services at some time. Seven percent rely both on internal staff and outside consultants, using the consultants to identify and track highly specialized and complex issues.

In 1985, most firms using outside suppliers did so in order to gain objectivity, reduce staff costs and obtain the advantages of the shared costs of multi-client surveys and studies. In 1986, most outside contractors were sought because of the technical nature of the issues (for example, tax reform, tort liability, and the more detailed aspects of the international trade question). The specialized information required to analyze such subjects was beyond the scope of most generalists.

One public affairs vice president, reflecting on his firm's tracking effort, noted:

"Our primary target for communication is the elected official, and we reach him by bringing as much of the company's resources to bear as we can muster.

"First, we identify issues and trends. Information is gathered from external sources, but officers and managers at all levels make the final identification.

"Second, we set priorities. Government affairs staff assists corporate officers in this, and a consensus is achieved. If the issue requires action, a project team is assembled and analysis is begun.

"A range of company positions and action plans are presented to the CEO. The final decision is his."

Briefing Top Management

Regardless of whether issues agendas are presented to top management formally or informally, through discussions, committee meetings, and the like, only one-third of the companies say their CEO participates in the issues-identification

process. Unit-level managers, however, have a strong role in developing an issues agenda in over three-fourths of the cases presented.

In 1985, 63 percent of the respondents did not use a formal issues agenda. In 1986, only 57 percent chose this practice. These companies prefer to use an issue-by-issue approach, or depend upon information from trade associations and informal discussions and meetings. Often, discussions rest upon senior executives' abilities to prioritize matters of concern to their companies. Procedures of some companies include the following:

"Special reports are prepared regarding selected issues. In addition, an issues survey is administered annually and results are widely circulated at the management level."

—a manufacturing company

"At the holding company level, a corporate policy council and corporate information council meet regularly to review company-related issues. At the operating level, an Executive Management Council of the officers meets regularly for the same purpose."

—a telecommunications company

"System company peer groups identify emerging issues which are presented to the system vice president and through him to the president's committee and the chairman."

—a utility company

A recent Conference Board report discusses in detail the role of task forces and committees, and how the committee mechanism serves both senior corporate management and the company as a whole. Based on survey information from 284 companies, the author reported:

"Task forces and special committees are presented in more than two out of five of the surveyed companies, and two in ten say that such groups have grown in importance during the past two years. Task forces are usually created in order to bring diverse internal expertise to the consideration of new issues while committees tend to deal with issues of continuing or intermittent concern. The terms, however, are often interchangeable.

"General Mills' Vice President for Public Affairs describes a committee that was created recently in connection with the discovery that a pesticide used by grain handlers as a fumigant was potentially carcinogenic: 'This was an issue that crossed departmental lines. We recognized that actions contemplated by governmental relations, legal, corporate communications, quality control, or operations group would have consequences in other areas and needed to be unified in order to have a coherent corporate strategy. So we put together an interdisciplinary team of legal, business, political, scientific and communications people chaired by a member of top management—in this case the Vice Chairman—to develop a strategy that would guide each of their functions but not be inconsistent with the strategies of the others. As long as mechanisms like this exist, conflicts between units are

Table 2: Ranking of Issues By Importance—Geopolitical Boundaries

Geopolitical Issues Category	Percent of Firms									
	1st 1986/1985		2nd 1986/1985		3rd 1986/1985		4th 1986/1985		5th 1986/1985	
National Issues	54%	53%	17%	21%	15%	11%	15%	15%	—	—
States Issues	31	33	40	41	18	20	9	6	2%	—
Local Issues	7	9	17	14	30	30	27	28	19	20%
International Issues	4	6	15	15	14	15	16	14	51	51
Regional Issues	3	2	11	10	33	27	28	35	25	25

Column totals may not add to 100% due to rounding.

minimized and organizational confusion avoided. In addition, we found that the quality of particular functional strategies was improved.¹

"Public affairs units normally provide staff support to task forces and special committees, but occasionally play a managing role as well. 'We typically gather and circulate information about an issue to members, ask for their input, and then hold sit-down sessions to establish its significance to the company and to develop a position,' the top public affairs executive at a manufacturing firm says."¹

Downsizing the Issues Management Function

Often, economic forces shape the size and direction of the issues-tracking effort. The senior vice president of a major conglomerate states:

"A major reorganization and cutback has drastically altered our issues management activities. But it has not been all that damaging.

"The question for me was, how can I maintain the same level of input, the same commitment on the part of plant managers to participate in the public policy process, without this interactive process? We decided to bring the issues process to the plant managers instead of vice versa.

"So far, it seems to be working. I can't honestly say that the cutbacks have hurt us functionally. We're a leaner operation now but, at the same time, more focused. We still seem to be able to do our job well, even though morale is low. Only time will tell."

While some companies did not respond to the survey—due to mergers and uncertainty as to the future of their unit, dissolution of the issues function, or downsizing of their companies—one-quarter of the firms did report having experienced a reduction in their issue-analysis function. Eleven percent of the companies responding had cutbacks of 25 percent or less, while 4 percent report cutbacks of between 25

and 50 percent. One firm's issues department was disbanded and a small portion of the respondents (2 percent) report cutbacks in excess of 60 percent.

Outside research assistance was sought on a variety of issues, many of them local. On a broader scale, the ramifications of the then-proposed tax reform (now a reality) caused 10 percent of the respondents to seek outside analysis. Trade issues accounted for 5 percent of the activity in outside services.

As mentioned earlier, the complexity of both the proposed tax changes and the implications of various trade bills placed these issues beyond the scope of issues management staffs; the drift toward outside assistance is not so much reflective of the corporate cutbacks as it is of the need for highly specialized skills. Other areas in which assistance was sought were health-care cost containment, South Africa disinvestment decisions, tort liability reform, and the federal budget deficit.

While 20 percent of the respondents sought outside assistance in 1985-1986, only 18 percent planned to do so in 1986-1987.

Geopolitical Concerns

As Table 2 illustrates, in 1986 national and state issues continued to receive the most attention from the firms surveyed—much as they did in 1985. But over half the companies studied allocate substantially more resources to national issues. However, nearly a third rank state issues first.

In 1985, it was the multinational companies that tended to give international issues priority. Those companies whose products are intended primarily for domestic markets were less apt to cite international issues as being of critical concern to their firms. By 1986, however, global economic and international trade questions had become increasingly important to domestic companies as well, and they began to press more aggressively for import controls.

As might be expected, businesses subject to state regulation—insurers, banks, telecommunications firms—continue to monitor carefully and devote substantial resources to state issues.

¹Seymour Lusterman, *The Organization and Staffing of Corporate Public Affairs*. The Conference Board, Report No. 895, 1987.

Levels of Corporate Involvement

For the purposes of this study, three levels of corporate involvement were identified, "active involvement," "close monitoring," and "general interest." (See Table 3.) Each level reflects a different allocation of company staff and resources, thus indicating the level of concern with a particular issue.

On issues of primary concern to the company, where the level of interest is reflected by an active lobbying effort, the support of advocacy groups that espouse the corporation's position, or the assignment of company staff and resources to a particular issue, companies are described as being "actively involved." These issues tend to be those thought likely to involve legislation that would—or could—impede a company's manufacturing or marketing operations. In a few cases, such as tax reform or trade policy, an issue may so significantly affect the overall economic climate of the country that a company will inevitably expect an impact.

Secondarily, companies may keep a wary and watchful eye on the development of an issue without any actual "involvement." In these cases, they have not yet committed themselves to a lobbying effort, or attempted to affect public debate by advertisements, public pronouncements, or support of advocacy groups. However, they are watching the issue closely through the use of company staff and outside resources, and are tracking and reporting on such developments. These companies are said to be in a stage of "close monitoring."

Third, companies may have merely an "intellectual interest" in the issue because of its general impact on the nation's economic and social system. These firms will expend no special effort to collect information on such an issue, but will keep themselves informed about its development.

The latter category of activity should prove useful to companies as they observe how long it takes an issue of "general interest" to achieve major significance or, conversely, how long an issue hovers in a "general interest" category before disappearing. Finally, as might be expected, there are some issues that firms say they pay no attention to at all.

How Companies Rank Issues

A list of issues that companies could choose from was provided in the survey. The issue topics selected for the survey come from several sources: the 1985 survey results; a polling of public affairs executives; and a regular review of secondary sources such as industry surveys, public opinion polls, tracking of media coverage, monitoring of legislative initiatives, and so on. In total, 24 separate issues were identified. (See box insert, page 10.)

Changes in the Issues Menu

Inevitably, there was substantial change in the menu of issues between 1985 and 1986. Some issues considered to be important in late 1984 and early 1985 were dropped from the 1986 survey. These were:

1. Federal reserve issues
2. Third World issues
3. Religion and business
4. Immigration reform
5. Aid to Israel
6. Ethnic discrimination
7. Age discrimination
8. Disarmament negotiations
9. Local community issues

Other issues, such as international investments, do not appear in the 1986 survey because the subject was too broad to elicit usable responses or conclusions.

Issues new to the 1986 survey appeared as a result of respondents' additions to the 1985 issues list. These are:

1. Public health
2. Tort liability reform
3. Privacy
4. Middle East
5. Farm prices and policies
6. Right-to-know
7. Specific environmental issues

A number of issues from 1985 reappear in 1986 but are worded differently. The topic entitled federal budget deficit and related tax reform has been separated into two separate issues, reflecting corporate commentary on the original phrasing. Regulatory reform has been replaced by deregulation; international trade has been divided into two parts: protectionism and the issue of technology and economic competitiveness. The topic of economic concentrations has been replaced by antitrust issues, and structural unemployment by job creation and/or retraining.

The Single Most Important Issue

When asked to describe the single issue of most pressing concern to their company, 30 percent of the respondents chose not to raise one key issue to that level of importance. Of those who did respond, more than one-quarter listed tax reform as the single most important issue affecting their company's profits. Deregulation was cited less frequently, by almost 14 percent of the panel, and protectionism ranked third, garnering an 11-percent response. Environmental issues, tort liability reform and technology and economic competitiveness followed closely behind.

If, however, the trade-related issues are grouped together—

- Deregulation
- Protectionism
- Technology and economic competitiveness
- Reregulation

—the picture changes considerably. Many respondents did, indeed, cite issues in this group as being of the most critical concern to their companies.

Table 3: Levels of Corporate Involvement in Public Policy Issues

Title of Issue	Percent of Firms Actively Involved or Closely Monitoring	Percent of Firms Actively Involved		Percent of Firms Closely Monitoring		Percent of Firms Reporting General Interest	
	1986	1986	1985	1986	1985	1986	1985
1. Tax Reform	94.1	70.1	*	24.0	*	5.9	*
2. Tort Liability Reform	78.2	47.3	*	30.9	*	20.5	*
3. Health-Care Cost Containment	74.4	39.9	41.2	34.5	37.0	22.0	18.1
4. Environmental Issues	67.1						
a. acid rain		24.7	—	24.7	—	24.2	—
b. clean air		32.4	—	26.5	—	22.8	—
c. toxic wastes		33.0	—	31.2	—	21.3	—
d. other		29.7	—	24.8	—	26.9	—
5. Deregulation	67.0	41.9	41.6	25.1	25.5	28.4	30.0
6. Technology and Economic Competitiveness	65.0						
a. research support		19.1	—	22.3	—	44.7	—
b. tax credits		32.1	—	30.7	—	28.4	—
c. copyrights and patents		17.9	—	22.2	—	41.5	—
d. science and engineering education		14.1	—	20.2	—	46.0	—
7. Financial Disclosure	63.5	15.3	19.8	48.2	42.8	30.2	30.5
8. Reregulation	59.9	25.3	31.5	32.6	31.1	34.8	29.5
9. Right-to-know	59.5	23.0	—	36.5	—	31.5	—
10. Protectionism	57.0	26.5	*	30.5	*	25.1	*
11. Employment Discrimination	57.0						
a. comparable worth/pay equity		12.2	15.2	44.6	50.6	41.0	30.0
b. handicapped		5.2	12.4	35.2	36.8	51.2	46.3
12. Campaign Financing Reform	59.9	13.0	20.2	43.9	43.2	35.4	29.2
13. Budget Deficit	54.2	16.1	*	38.1	*	43.9	*
14. Plant-Closing Statutes	51.1	19.3	19.8	31.8	33.7	37.7	29.2
15. Employment-at-will	48.4	5.9	7.8	42.5	41.2	47.5	41.2
16. Antitrust	36.8	9.9	14.8	26.9	43.2	48.9	37.0
17. Family Issues	34.5	5.8	7.9	28.7	25.7	53.4	54.8
18. South Africa	33.8	16.2	12.5	17.6	13.8	30.2	19.2
19. Privacy	33.3	4.9	—	28.4	—	59.0	—
20. Public Health	32.3	12.6	—	20.3	—	50.9	—
21. Job Creation and/or Retraining	30.7	5.0	7.9	25.7	16.7	51.4	55.8
22. Education and Business	20.8	10.4	21.0	10.4	19.8	49.5	45.7
23. Middle East	19.3	4.5	—	14.8	—	35.9	—
24. Farm Prices	15.5	5.5	—	10.0	—	30.0	—

* Appeared in the 1985 Survey but in a different form

— Not included in the 1985 Survey

The Ten Most Important Issues

Issues are weighed in two ways in this report. First, companies report on their degree of involvement and concern (Table 3, page 8). Second, companies are asked to rank the top ten most important issues affecting their firms, selecting from among the 24 issues available, or going beyond the given list. The following areas, listed by frequency of mention, received the most comment:

1. Tax reform
2. Environmental issues
3. Tort liability reform
4. Health care
5. Deregulation
6. Protectionism
7. Technology and economic competitiveness
8. Reregulation
9. Budget deficit
10. South Africa
11. Public health issues
12. Plant-closing statutes

By contrast, the 1985 rankings were as follows:

1. The federal budget and related tax reform
2. Regulatory reform
3. Environmental protection
4. Energy development
5. International trade relations
6. Health-care cost containment
7. Economic concentration
8. Local issues
9. South African investment
10. Plant-closing laws

Tax reform has clearly been a major concern of an overwhelming majority of companies for the last two years and will probably continue to be while there is still uncertainty as to the fallout from the new tax law. Over 50 percent of the companies are actively involved with a variety of environmental issues, citing "the disposal of toxic wastes as the single most critical issue of our time." More than one-third of the companies say tort liability reform is "long overdue" and increased litigation will "cripple their industry unless brought under control." Health-care cost containment continues to preoccupy management in one-third of the companies responding, while energy, telecommunications and transit regulations are no longer seen as high-priority issues. The years 1987 and 1988 will probably see renewed concern over banking and financial services regulation as Wall Street insider-trading scandals develop further.

The appearance of the issue of technology and economic competitiveness among the top ten serves as an umbrella for the various free trade, protectionism, regulatory reform, productivity, and standard-of-living questions that will be the subject of much debate in Congress.

Company Commentary on Key Issues

Company spokespersons are asked to comment on issues of particular concern to their companies and to elaborate on the reasons for that concern. The following areas received not only the most frequent, but also the most thoughtful, comment.

Tax Reform

The ramifications of changes in tax policy preoccupied almost all respondents to the survey. They recognized that the public was dissatisfied with what it perceived to be the unfairness of the tax system and was calling for change. Although tax reform proposals had surfaced frequently, they had never been successfully maneuvered through the Congressional shoals. Many expected the proposal to fail again.

Business was not united in its approach to tax reform. Some business groups—and some individual companies—chose to associate themselves with the reform movement, believing it to be strongly market-oriented because of its promise to radically lower tax rates and foster productive investments rather than encourage tax shelters.

Needless to say, companies that find themselves in the top 500 U.S. taxpayers' category look with favor on the tax reform act. Others, however, believe that revenue proposals for continued deficit reduction will threaten corporate earnings. Energy companies are particularly sensitive in this regard:

"The trend will be, at all levels of government, to shift public sector costs away from individuals toward business. Federal tax reform will impact on state taxation, as will declining oil prices. The energy industry will continue to remain a prime target for tax increases."

—an oil company spokesperson

State and local tax questions were a high-priority item on many companies' lists, particularly in states facing huge financial problems, such as Texas. An agricultural products manufacturer writes, "as a result of federal tax reform, we foresee pressure on the states to return windfalls to the taxpayer."

Some respondents were skeptical as to the probable success of the new tax reform plan, which at the time of the survey had not yet become law. Comments include:

"Past experience indicates Congress will revisit this issue annually."

—a diversified consumer goods manufacturer

"Tinkering will continue, even with passage of this bill."

—a rubber products manufacturer

"It won't end here. There will be continual pressure to change our method of raising taxes. It will shift from income to consumption. We are monitoring this issue very carefully."

—a food products manufacturer

"The elimination of the investment tax credit and changes

Issues Descriptions

*** Aid to Israel:** Implication of extended aid to firms with buy-back responsibilities and those doing business in the Middle East.

—Antitrust Issues: Junk-bond financing of mergers.

—Budget Deficit: The continuing struggle to achieve a balanced budget: Gramm-Rudmann-Hollings, etc.

—Campaign Financing Reform: PACs

—Deregulation: Further relaxation of regulations affecting business.

*** Disarmament Negotiations:** The efforts and strategies to gain mutual arms reduction.

Education and Business: New federal aid to institutions; participation in the performance and structural aspects of the educational system.

Employment Discrimination:

- a. Age: Issues involved in promotion, forced retirement, new employment.
- b. Comparable worth/pay equity: The claim that the relative wage levels of jobs should be equitable and not affected by gender discrimination.
- c. Ethnic discrimination: Discrimination by race, creed or nationality.
- d. Handicapped: Training and provision of facilities to encourage employment of the handicapped.

Employment-at-Will: The doctrine addressing wrongful discharges and the issue of employment security.

—Environmental Issues:

- a. acid rain
- b. clean air
- c. toxic waste
- d. others

Family Issues: Day-care assistance, part-time work with prorated benefits, maternity leave as a disability.

**** Farm Prices/Policies:** Low income and high debt leading to increasing foreclosures.

*** Federal Reserve Issues:** The effect of monetary policy on interest rates; oversight; lobbying to limit the powers of the Federal Reserve Bank.

Financial Disclosure: Additional requirements regarding the release of company finances and operating results to the public, stock analysts, the media, etc.

Health-Care Cost Containment: Regulations to help contain costs by limiting doctors' fees, hospital growth; related delivery-system efficiencies.

*** Immigration Reform:** Proposed employee identification; employer liability for the hiring of aliens.

*** International Investments:** Issues of joint ownership; technology transfer; expropriation; repatriation of assets; protection of facilities and employees against terrorist attacks.

Job Creation and/or Retraining: The effects of long-term changes in labor pool requirements.

*** Local Community Issues:** Housing, zoning, industrial development, crime, etc.

**** Middle East:** The resolution of political issues.

Plant Closing Statutes: Regulations regarding the closure of plants, strictures on location of new facilities.

**** Privacy:** An employer's need-to-know in conflict with an employee's civil right to privacy.

—Protectionism: Competition from foreign imports, subsidies, loan guarantees.

**** Public Health Issues:** AIDS, Medicare.

*** Religion and Business:** The impact on business of organized religious groups' advocacy of their interests.

**** Right-to-Know Issues:** Workers' and communities' rights regarding disclosure by firms of potentially hazardous products or processes.

Reregulation: Reimposition of regulation in selected business sectors.

South Africa: Apartheid, disinvestment.

*** Structural Unemployment:** Retraining workers and redirecting students' career choices to reflect long-term changes in labor pool requirements.

—Tax Reform: The impact of proposed changes in U.S. tax policy.

**** Technology and Economic Competitiveness:** Research support, tax credits, copyrights and patents, science and engineering education.

*** Third World Issues:** The extent of concern regarding safety and public health issues in Third World countries.

**** Tort Liability Reform:** The effects of court costs, liability insurance, and the development of alternative systems.

Key:

*** Issue dropped out of 1986 Survey**

**** New Issue for 1986 Survey**

—Issue appeared in 1985 Survey but in a different form (No symbol) Issue unchanged from 1985 Survey.

in depreciation will have a serious impact on our industry's future growth."

—an aviation industry officer

"Implementing the Gramm-Rudman balanced-budget bill will cause chaos."

—a brewery

Environmental

With renewal of the "Superfund" toxic-waste program and uncertainty about the Clean Water Act resolved, corporate concern over implementation of these programs will continue. Not only are environmental programs costly, but business wonders if these programs are capable of meeting their aims.

Survey respondents expect acid rain legislation to be a top Congressional priority, with Members divided along regional lines. Midwestern and coal-producing states are pitted against the Northeast, which eventually receives much of the sulfur dioxide and other pollutants transported through the air and falling as acid rain.

Of all the environmental issues mentioned, none was a more pressing management concern than toxic waste disposal; companies see no easy or immediate solution. A metals manufacturer comments: "Public hysteria over toxic waste treatment and disposal is paralyzing the industry; yet the wastes continue to be generated." Other comments include:

"Hazardous waste disposal will produce more regulation at the state and national level."

—a forest products company

"Toxic substance exposure control and clean-up will remain issues for many years."

—a chemical company

"Control technology will not be able to keep up with detection capability, as regulators will be searching more intently for ways to control the discharge and disposal of toxic substances. Risk assessment will need to be expanded."

—a paper producer

"The erroneous perception of an industry with deep pockets will place additional unrecoverable burdens on the oil business."

—a petroleum products firm

Chemical companies displayed an intense interest in hazardous chemicals, saying the "control and reporting of defined hazardous chemicals used in the manufacturing process can have a significant effect on the cost of our products." And another respondent says: "Waste minimization and ground-water quality are issues which can, when handled properly, positively affect our company. If handled poorly, there could be a strong, negative impact."

A waste management company states: "We will continue to evaluate landfills, incineration and recycling to see that our wastes are handled economically and with community

approval. Without community and governmental approval, we will surely have to close our chemical operations."

Utility companies continue to identify acid rain as a major concern both to their companies and to the industry as a whole. A western utility company executive writes: "Generating-plant scrubbers are an extremely expensive and still questionable remedy. They need to be given the opportunity to demonstrate environmental efficiency. Chief among the technologies available is front-end cleaning."

But some businesses' problems are opportunities for others. A Western gas company officer comments: "Stringent acid rain and air pollution guidelines will impact the cost of electricity and make gas more competitive."

Tort Liability Reform

Concern about tort liability and commercial insurance reached its highest level of attention to date in 1986. As another Conference Board study has shown, the media was replete with "warnings of impending breakdowns in the insurance industry and predictions of dire consequences for business and the economy in general unless serious reforms were enacted."² Tort reforms were passed in about 40 state legislatures.

Public affairs officers of the companies responding to this study said they feared the pressures brought on other units of their firms by the proliferation of product liability lawsuits, while at the same time noting that there is pressure brought to bear on them to develop better and safer products, labels and use-instructions. They feared that insurance would become either unavailable or so high as to preclude the production of competitively priced products.

Those industries most frequently citing concern with these issues are food-products manufacturers, chemical and pharmaceutical companies, and airlines.

Companies see their active involvement in this issue continuing. Some will continue to lobby at the state level; others will have more broadly-based activities:

"Our firm will continue to take an active role in shaping tort reform at the local, state and national level."

—an insurance firm

Some companies, however, are critical of state response to this issue:

"State governments are reacting to the crisis without understanding the etiology. Much more needs to be done in collecting and analyzing data to allow for lawmakers to make informed decisions about insurance company regulation and tort reform."

—an agricultural products manufacturer

²Nathan Weber, *Product Liability: The Corporate Response*. The Conference Board, Report No. 893, 1987.

Increased costs—or the expectation of increased costs—are an important factor in company deliberations:

"Prices have skyrocketed, especially for directors. Insurance premiums generally are increasing the cost of doing business."

—a retailer

Several companies expressed concern with product liability, calling for "a major reform in this area," the need for which is "obvious and widespread." An insurer writes, "tort reform must be implemented to cut costs to society." The aviation industry sees the need for "available and affordable insurance protection against catastrophic accident."

Firms are concerned with both the short and long-term impacts of this issue:

"The escalating product liability judgments and their actual and potential impact on our near-term business and future product line is a continual concern."

—a chemicals manufacturer

"The long-term impact on the regulation of the entire insurance industry makes this more than a property/casualty issue."

—an insurance firm

"The move to reform must continue even if insurers' results improve. Insurance is not the only element of the U.S. society that is harmed by the present system."

—an insurance firm

Deregulation

Companies are calling for increased deregulation, particularly in the financial services sector. Financial institutions are now performing a multiplicity of services, and the number of regulators on both the state and federal levels is often called into question.

At the same time, the problems that the trucking and airline industries have experienced following deregulation are keeping companies watchful. The rise in the number of trucking accidents, the rate of failure of licensed motor carriers, the concentration of airlines, and the ensuing decline in services and reliability are causing companies to realize that further deregulation will need to be accompanied by careful legislative consideration of problems and solutions.

In responding to this survey, utilities, telecommunications firms and banks were predictably among those industries pressing for further deregulation. A gas company executive comments: "Deregulation of gas prices makes the marketplace much more volatile than in the past. This, combined with tax rate changes, will affect our rate of return and our future pricing to customers."

Suppliers of electricity are particularly concerned with the complexities of cogeneration, which involves "the marketing of our capital investment to serve customers." Other suppliers of energy foresee the increased vulnerability of the U.S. to foreign oil, resulting in legislation intended to spur greater self-sufficiency.

The banking community looks to increased deregulation of their services, calling for "the consideration of nationwide interstate banking" and "increased provision of products and services, i.e. increased powers." Telecommunications companies see the public policy issues in their industry becoming increasingly significant, particularly "equal access of the local telecommunications network and deregulation at the state levels."

Finally, a major airline calls for "the need to continue the process of deregulation to assure our industry is not treated differently or unfairly with respect to other deregulated industries."

Protectionism

Last year's \$170 billion trade deficit has some businesses and industries calling for strongly protectionist trade measures. Senate and House leaders, however, know that the bill they shepherd through the legislative process has to be taken seriously by our competitors abroad, while at the same time not forcing the White House into a veto.

There is a strong push from business and industry to retaliate against countries accused of keeping out U.S. exports; for example, Japan's policies regarding U.S. computers and the Common Market's agricultural policies. (In early 1987, the Reagan Administration imposed a \$300 million tariff penalty on Japanese semiconductor producers in retaliation for their dumping of such products in Third World nations.)

The debate will continue over the wisdom or folly of trade protection policies. Predictably, the automotive industry and its suppliers were among the firms lobbying most actively for protectionist legislation. Construction-related companies were not far behind:

"Unless the industry obtains significant relief, unfair trade will become more serious as the economy weakens and demand declines."

—a cement manufacturer

Other industries calling for stronger protective measures are metals manufacturers, electronics companies, and textile firms.

There was, however, almost an equal number of respondents that eschewed protectionist legislation. The banking community sees protectionism as "a major threat to the global economy." Retailers claim their "general merchandise companies rely heavily on imports." Two companies see serious flaws in U.S. promotion of exports:

"If the United States did a better job in assuring a positive climate for exports, protectionist pressures would diminish."

—a farm equipment company

"U.S. trade policies continue to give imports an advantage and the 'high dollar,' plus non-tariff restrictions in foreign countries, make it difficult to export U.S. products."

—a food products company

Several companies see the heart of the protectionist issues

in neither the 'high dollar' nor export policy, but in government subsidy of certain industries and exports. Among these comments were:

"One of our product lines is subject to dumping by the European Community into the United States, and is further affected by the European Community's use of huge subsidies."

—a food products company

"The future of the industry and large segments of our company will be impacted greatly by international competition, U.S. trade policies and, more importantly, the policies foreign governments adopt."

—an automobile manufacturer

"We need rules that 'level the playing field' for competition between private, profit-motivated business and state-operated or supported business, which has no requirement to show a profit."

—an airline

A few companies believe they can operate in either climate—free trade or protectionist—as long as they can plan for, and adapt to, change:

"Our company can operate successfully with or without protection from imports. We must, however, base our decisions on existing circumstances or circumstances as we expect them to change."

—a shoe manufacturer

Technology and Economic Competitiveness

The past several years have witnessed the decline of the value of the U.S. share of world trade in manufactured goods. At the same time, the global economic picture has changed as new industries in foreign countries have exported successfully to the United States products that used to be considered distinctly U.S.-made; for example, automobiles, apparel and home appliances. At the same time, U.S. business sees the lead for products based on innovative technologies; for example, semiconductors, also being captured abroad.

Several companies responding to the survey saw the move toward "competitiveness" as requiring a fundamental change in U.S. management values. A major effort to revive the U.S. economy will be needed to affect growing capital formation problems and unresolved budget and trade deficits.

The telecommunications industry expects its competitive position to be constrained by elements of the tax reform bill:

"The investment tax credit has been of great value in encouraging investment in plant facilities. Its elimination is of singular significance to capital-intensive industries, particularly infrastructure industries like telecommunications where improvement in productivity is achieved through technological innovation."

—telephone company

Other comments include:

"We are concerned primarily with the use of technology

to enhance productivity, particularly regarding our ability to offer bank services to business via microcomputers."

—a western bank

"Educational improvements are essential if we are to keep pace. We see a short-fall in engineering curricula development and vocational training in secondary schools."

—a structural products company

"Intellectual property matters are a major concern for us. We need patent and trademark rights and protection at both the domestic and international levels. Technology is our greatest competitive advantage and we must move to protect ourselves against theft of our technology by pirates, counterfeiters and others."

—a pharmaceuticals firm

Some firms were concerned with the lack of public education in areas of biotechnology research and innovation. Discussion of genetic engineering of food plants is often fueled by "the public's general fear of anything new in science," writes an executive for a food products company.

Other Significant Issues

Public health concerns are shifting from drug and alcohol abuse to AIDS, and from treatment and disciplinary actions to right-to-know and privacy. Health-care cost containment continues as a concern, despite some abatement in the rate of cost escalation. Benefits to early retirees, threats to the quality of care delivered, access to top new technologies, and the value of corporate wellness programs were cited as continuing interests. Legislation to control health-care costs "affects prices that can be charged for products and services. These must be discontinued if costs can't be reduced. Companies must be able to make a reasonable profit if we are to continue to fund research for new products and technologies," says a health-care products manufacturer.

Federal revenue shortfalls are predicted by many. The new tax bill is not expected to yield the revenues projected from business, and continued federal budget deficits are expected to cause pressure, once again, for increased taxation.

Employment discrimination issues have shifted somewhat. Age and ethnic discrimination issues fell below a recordable percentage in this study, while comparable worth/pay equity issues and discrimination against the handicapped still ranked high.

Banks and financial institutions raised a series of issues critical to their businesses: demographic changes, economic revitalization, small business support, international debt, consumer legislation reform, and interstate bank deregulation.

Interest in South Africa has dropped, reflecting the decision of many companies to withdraw; disinvestment is no longer a question within many companies.

Methods Used to Affect Issues

Respondents were asked to comment on which of the methods available to them are most effective in persuading

key constituent groups to support their views on a particular public policy issue. Public affairs officers were asked to rank and comment on the seven principal methods used below.

(1) Working through trade associations. More than three-fourths of the companies responding identify their trade associations as the most effective tool available to them in affecting the outcome of a public policy debate. This represents a significant shift from 1985, when single-issue lobbying was the primary method for most firms, and only two-thirds of the companies chose trade associations as the most effective mechanism.

"Active participation in our trade association has been very useful to our company. At first, we felt that our association was too large, and the interests of the member firms too diverse, to represent my company adequately. We decided to take a more active role in the association's policy committees, which helped define our position.

"And, of course, the sheer weight of the organization, the number of companies supporting the trade association, has an effect for us in Washington."

—a machine tool manufacturer

(2) Single issue lobbying. This method involves a company and its representatives most intensively. It entails testifying before legislative bodies, writing articles, meeting with interest groups, and, often, hiring specialists to represent the company's interests before state and/or national governments.

"We use lobbyists almost exclusively—perhaps more than we should. If we involved ourselves in an issue in the early stages, we would have less need of professional lobbyists. By the time our senior management takes a serious look at the staff's early identification of the issue, it is too late to do more than add to a trade association's momentum by hiring our own lobbyist.

"In cases where the issue is critical to us, and is finally recognized as such, we go to the best lobbyist we can find. While we have never successfully blocked legislation, we have succeeded in amending bills so that we wind up with something everyone can live with."

—an insurance company

(3) Working with groups of companies. Two-thirds of the companies responding seek coalitions of like-minded companies as a method of affecting a public policy issue. This percentage remains unchanged from 1985 to 1986. Most of these companies do so because there is not an effective trade association available to them, or because there is disagreement among corporate members of an existing association. This was seen most often among manufacturing companies whose regulatory concerns are specific to their industry—or company—alone.

"Our trade association represents so many companies in our industry group that there was no way they could assign

the number of people needed to influence the legislation before Congress that concerns recreational boaters and fishermen.

"Coalitions of specific businesses and industries, whose prime market was those consumers directly affected by pending legislation, were particularly effective."

—a recreational vehicles manufacturer

(4) Supporting those candidates who share company views. Almost a third of the companies responding to the survey work with advocacy groups to affect the outcome of an issues debate; this is up slightly from 1985. Firms do so at either the local or national level. At the local level, it seems to be the result of lessons learned:

"Our failures in the past occurred because we were unwilling to become involved in local issues until a confrontation with a public interest group had taken place. We preferred to keep a hands-off policy in local disputes, assuming the adversaries would disperse. As a result, it was often too late for us to gather the community support needed to guarantee a receptive audience for our position. This was particularly true in 'right-to-know' questions.

"Now we involve advocacy and public interest groups as soon as we sense a problem is surfacing. We work with them now, not against them."

—a waste management company

(5) Paid advertisements in specialty or general media. Only five percent of the respondents routinely use paid advertisements to influence a decision in the public policy arena. Companies do, however, make use of "institutional" advertising, in which they promote the image of their company rather than try to sell a point of view on a particular issue.

(6) Other means. Fourteen percent of the respondents occasionally use a variety of other methods, often a combination of those described above. This is occasionally augmented by the use of public relations consultants brought in to "polish" the staff work before it is given extensive public airing.

Looking Ahead

When asked to forecast which issues were likely to emerge and become critical to their companies in the next three years, public affairs officers tended to point to a continuing concern with current issues rather than the emergence of new topics. Issues they believe will be of concern through 1990 include:

- (1) Tax reform
- (2) Environmental issues
- (3) Protectionism
- (4) Deregulation
- (5) Tort liability reform

The response to the same question in 1985 was:

- (1) Tax reform

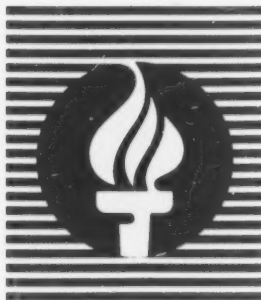
- (2) Deregulation
- (3) Federal budget deficit
- (4) Environmental protection
- (5) International trade

Trade protectionism or competitiveness was mentioned often, and trade legislation is expected in 1987. The concerns expressed swung widely between those favoring much tighter import controls and quota legislation, and those favoring more conciliatory solutions.

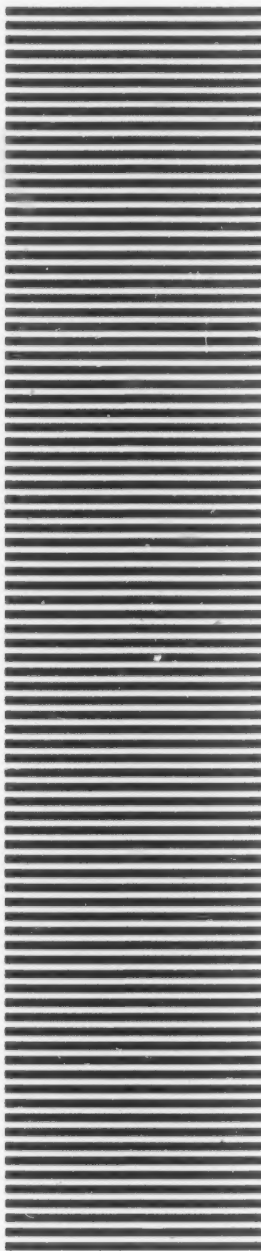
AIDS and what corporations are able—or ought—to do concerned almost all those polled. The outright costs to business, the privacy rights of victims, the right-to-know of fellow workers, and the profound changes in social and workplace relationships that will occur are likely to concern corporations for years to come.

Between the time this survey was taken and the time this report went to press, the Administration's arms-sale crisis occurred. Conference Board researchers undertook a telephone poll to see if public affairs officers' forecasts had changed as a result of investigations underway.

Before the scandal, respondents had predicted some consensus between the Administration and the 100th Congress. That relationship, some said, would now be characterized by "confrontation." Some respondents foresaw further substantial staff and agency changes in the Administration. Those respondents involved in PACs and, therefore, political campaigns, see the preoccupation with these foreign policy issues continuing through the 1988 election. They cite the lengthy nature of the investigations, comparing them to the inquiry into former vice-presidential candidate Geraldine Ferraro's finances—which took 30 months to complete.



The Conference Board



U.S. Economic Outlook 1987-88

- *moderate 2½-3% growth*
- *"unthreatening" 4-4½% inflation*
- *foreign trade turnaround to offset slack in housing, consumer and defense spending*
- *sustained cut in budget deficit uncertain*

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Chewing Over Old Policy Issues

Edgar R. Fiedler

The spring meeting of The Conference Board's Forum reported a relatively favorable outlook, and it did so with an unusual degree of concordance. The U.S. economy continues to chug upward with a mild case of inflation that, for a while at least, does not threaten to become virulent.

Although minor quibbling was heard about the extent to which this comparatively old business cycle may be tired and infirm, all members of the Forum agreed that the expansion still has a good bit of staying power. They see no recession on the horizon this year or next. The overall pace of advance is projected at a moderate speed.

Several major sectors of the economy are expected to show slower growth over the next eighteen months. The military buildup is being constrained by budget pressures. Housing will be held back by rising interest rates and, on the multi-family side, by high vacancy rates and tax reform. Consumers, although they appear both able and willing to increase their spending as their incomes climb, no longer are in a position to splurge, as they could during the past couple of years, by pulling down their saving rate. Business investment is on a different track, declining last year mostly because of the collapse of oil drilling but also because of the Tax Reform Act. From here on, capital goods outlays are likely to recover, but only gradually.

If these major sectors aren't going to provide much oomph, what will keep the economy moving forward at a respectable pace? The nearly unanimous answer is the turnaround in foreign trade. The international tide is turning, at long last. Since late 1986, a slowing of the growth of imports—coupled with rising exports—has been adding to economic demand in the United States. How big a boost this will produce is unknown, but it represents a striking contrast to the past few years, when foreign trade was a heavy drain on U.S. growth.

These offsetting forces create a modest second wind for the expansion, which thereby remains on the same satisfactory but not boomy growth track it's been following since mid-1984—about 3 percent this year and 2½ percent in 1988, as forecast by the Forum members (see table). What is most remarkable about the projections is their near uniformity. You could throw a blanket over the whole group. To find a dozen forecasters in 1987 projecting the 1988 growth rate within a range of only 2½ percentage points is extraordinary.

The high degree of consensus does not mean, of course, that the outlook is without uncertainty. For example, there's unexpected strength in many reports, from a wide range of industry sources, of surprisingly heavy incoming orders in March and April. Another positive signal was April's sharp drop in unemployment (released just after the Forum meeting). On the other side, the group worried about the recent rise in long-term interest rates, especially its impact on housing. The prevailing judgment, however, is that the rise in interest rates thus far is not enough to choke off the business-cycle expan-

Edgar R. Fiedler

Significant deficit reduction could vanish.



sion. But if rates were to climb another percentage point or two, all bets on a continuing expansion would be off.

Expectations of inflation also show a high degree of consensus. Last year, inflation was temporarily stifled by the collapse of crude-oil prices. With that deflection behind us, the 1987 inflation rate has returned to the 3½-4 percent norm of the past few years. Looking ahead to 1988, in the eyes of Forum members, the continued economic expansion—combined with upward price pressures in the foreign-traded goods sector—will push the inflation rate up to about 4½ percent. Yet there's no sense of any higher rate than that, because there are no upward pressures from the wage side right now.

Policy Accords and Discords

Although most dimensions of the outlook produced uncommon conformance, discussion of policy had quite another tone. The Forum meeting followed close on the heels of Federal Reserve Chairman Volcker's announcement that monetary policy has been "snugged" recently. Within the Forum, some thought this action appropriate; others disapproved. The central difference on this point is the oft-chewed-over question of how close the U.S. economy is to full capacity operations. According to some, the economy is closing in on its capacity constraints, so that it has little room left for further expansion (over and above the painfully gradual advance in the labor force and productivity). If so, then avoidance of a new surge of inflation will require some tightening of policy by the Fed, or at least a less affirmatively accommodative policy than has been pursued through 1986.

As the analysts on this side of the issue view it, the recent run-up in interest rates is much less a result of Federal Reserve "snugging" than a reflection of continued economic advance. Over the past two years, despite what has been repeatedly described as a sluggish economy, total activity has expanded enough to reduce unemployment from over 7 percent to around 6¼ percent. When the rate was near 7 percent, the economy contained some slack, and the trend of interest rates was slightly downward. With unemployment now approaching 6 percent, the slack is gone, and the interest rates are tilting upward. In other words, these analysts see the economy in the process

THE FORUM CONSENSUS
Results of a Pre-Meeting Outlook Survey

	1986 <i>Actual</i>	<i>Projected</i>			
		1987		1988	
		<i>Median</i>	<i>Range</i>	<i>Median</i>	<i>Range</i>
Economic Growth (Real GNP, percent change)	2.0%	2.9%	2.3-3.5%	2.6%	1.0-3.5%
Inflation Rate (GNP Deflator, percent change)	2.1	3.8	3.0-4.5	4.5	3.8-5.0
Corporate Profits (After taxes, percent change)	3.4	12	5-20	9	5-20
Unemployment Rate (Percent, average during fourth quarter)	6.8	6.5	6.0-6.8	6.3	5.7-7.0
Commercial Bank Prime Rate (Percent, average during fourth quarter)	7½	8¼	7½-9	8¾	7½-11
	<i>FY1986</i>	<i>FY1987</i>		<i>FY1988</i>	
Federal Budget Deficit (Billions of dollars)	\$221	\$187	\$180-200	\$168	\$150-190

Note: These forecasts incorporate submission by Forum participants in early May, and are based on data available at the time. For growth, inflation and profits, the annual forecasts are the percent change over the four quarters of the year, i.e., from 1986:IV to 1987:IV.

of passing through the "full employment" zone, making the gradual transition from buyers' to sellers' markets. Thus it is time for the Fed to start thinking about congested markets and accelerating inflation.

Those who take the other side of the argument are persuaded that 6¼ percent unemployment remains an appreciable distance from full capacity operations, and that Fed policy, especially as measured by real interest rates, has not been accommodative enough to date. They contend that the modest inflationary pressures now being felt in foreign-traded goods should not be countered by macroeconomic policy. These price pressures arise not from domestic conditions but from the fall in the dollar. When the dollar was rising, especially in 1983-84, the United States enjoyed the resulting disinflationary bonus, while our trading partners had to put up with the corresponding price increases in their economies. Now, with the dollar going the other way, we have to "repay" our trading partners for the disinflation we borrowed from them earlier. Consequently, these current inflationary pressures are unavoidable, except at severely wasteful cost, and the Fed has no business trying to stabilize the exchange value of the dollar by tightening monetary policy. Besides, they argue, the process is only temporary; once the dollar stops falling, the price pressures will abate shortly.

The other major policy issue considered by the Forum, the "twin deficits" in the Federal budget and foreign trade, is also one that has been chewed over many times in recent years. Actually, this policy question generated quick agreement without lengthy debate; the group simply accepted the proposition that

a sustained and substantial reduction in the international deficit—if it is to be achieved without serious repercussions to the domestic economy—will require a sustained and substantial reduction in the budget deficit. There was also a general feeling that a further hefty drop in the exchange value of the dollar would be part of the process.

Even if setting the two deficits right can be accomplished without putting the economy or at least the financial markets through the wringer, the process does have costs. In particular, it will mean that Americans must give up some of the extra gratification we've enjoyed during our consumption binge of recent years. Specifically, we will have to reduce the growth of consumption a percentage point or so below the growth of total output for, say, four years. That may be acceptable as long as GNP advances at a reasonably brisk and steady pace but, if not, the American people may be very irritated and resentful about being required to constrain their personal spending.

To what extent the budget deficit is likely to be cut is not at all clear. Unlike other dimensions of the forecast, estimates of the deficit did not fall within a narrow consensus. The group split into two camps: half looked for the deficit to come down to \$150-160 billion in FY1988, while the more pessimistic half saw the deficit holding at \$180-190 billion. Neither estimate brings the budget near the Gramm-Rudman-Hollings target of \$108 billion for FY1988. How that particular legislation will be buried is uncertain, but there is no doubt Gramm-Rudman-Hollings is dead, at least in its original form.

The Forum's two members from Washington, D.C. provid-

ed reasons for pessimism about the budget. Gail Fosler pointed to the many spending programs for which increased budget authority was being seriously considered, including education, jobs, the homeless, the environment, space, science, child care, Medicaid, AIDS research, law enforcement, election financing reform, drugs and catastrophic health insurance. These spending pressures reflect the lack of consensus on national issues, the polarization between the White House and Congress on budget issues, and a profound disinterest in budget issues generally and in the deficit in particular.

Robert Reischauer reported a different view in part. In terms of public attitudes, he noted, the present is an opportune time to do something about the deficit. Most Americans feel good about their personal economic situation, and they have become more realistic about the steps that must be taken to deal with the deficit. Thus they are ready, albeit reluctantly, to accept the pain of higher taxes.

Politically, however, Reischauer observed that bringing

down the deficit has become even more difficult. With the Democrats in control of both House and Senate, budget policy has inevitably become more partisan and contentious. The moderate Senate Republicans are now less likely to search for common ground with the Democrats. And the White House has less reason to mute its criticism, now that budget plans emanating from the Hill do not carry a made-partly-by-Republicans label. Thus the President may finally put into effect the "scorched pen" veto policy he has often threatened in opposition to Congressional budget priorities.

If so, the possibility of significant deficit reduction could vanish in a budget stalemate. With it, we may lose our best hope for a sustained and substantial reduction in the international deficit without bringing on recession or higher inflation or both. Those unhappy repercussions are not likely to appear, in the view of the Forum, until sometime after 1988. But if and when they do, they will be no less unwelcome and no less damaging.

The Cyclical Setting

Richard W. Everett

In this review of the U.S. business cycle I will try to stick to the facts and leave the forecasting to others. The first fact I offer is that the current economic expansion is very old—not just aging but ancient. Through May, 1987, the expansion that began in late 1982 is 4½ years old. Only one purely peacetime expansion period, out of more than two dozen since 1854, lasted longer.

Age has taken its toll. Each of the major sectors of the private economy made a major contribution to growth at some time in the past 54 months, but the vigor just isn't there any more. Consumers continue to spend money with almost unparalleled enthusiasm, but another jump in their spending would require a greater increase in income than seems in prospect. Special sales promotions that generated automobile sales at annual rates of 16.2 million units last September and 13.6 million units last December are now required to hold sales up to 10 million units. Business investment boomed through 1984, but gains since have been erratic and unimpressive. Housing construction recovered nicely in 1983 and had something of a boom a year ago. Now tax reform and high vacancy rates are restraining apartment building; single-family housing is holding up, but we can't expect much growth there. And budgetary constraints limit increases in public spending.

As things stand, a slow and somewhat halting pace is all we are likely to get out of this old expansion. A substantial reversal in the long deterioration in our trade balance is my



Richard W. Everett

Our economic health has come to depend on the rest of the world.

only obvious candidate as a rejuvenating influence. In fact, we may need that just to keep going.

I described this as a "peacetime" expansion. That's true, but perhaps a bit misleading. There has been a buildup in military spending that is unprecedented for a period without a war; military spending increased by more than 40 percent in real terms in the five fiscal years after 1981. The buildup is now ending.

My second fact is that economic policy has been extremely expansionary for the past five years or so. When it comes to pump-priming, the New Dealers were a bunch of misers. Federal deficits averaged 3 percent of GNP during the 1930's, when the national unemployment rate averaged 18 percent. For the

past five years, the deficit has averaged 5.2 percent of GNP. The ratio is lower now, but still extremely high. As for monetary policy, I find it hard to assess these days, but it strikes me as having ranged from accommodative to downright permissive through most of the expansion period.

The third and final fact is that our economic health has come to depend on the rest of the world in a degree unmatched since we were a developing nation. We consume more than we produce. We demand far more from government than we are willing to pay for, and we save too little to finance the resulting governmental deficits plus private investment. This was

an easy way of life for a while, especially while the U.S. dollar was strong in the foreign-exchange markets. There were adverse effects for some Americans, of course, but the rest of us prospered. But now the United States is the world's greatest debtor, and requires more than \$100 billion of new foreign capital to sustain itself. The dollar is cheap, and no longer the barrier to domestic inflation that it once was.

We have made ourselves hostage to the behavior of our creditors. If they tire of financing us on terms that are comfortable to us, the cyclical setting could quickly become recessionary.

Can the Nation's Economic House Be Put in Order for the 1990's?

Robert D. Reischauer

Recent public opinion polls suggest that this would be a good time for policymakers to begin a serious effort to reduce the budget and trade deficits and thus put the nation's economic house in order for the 1990's. The U.S. public is fairly satisfied with current conditions; yet there is concern about the economy and the deficits, as well as a growing awareness that some sacrifice will be required to get the economy back on a more even keel. Whether the nation's political leaders take advantage of this opportunity for meaningful action before it passes remains to be seen.

For the past year, Americans have expressed very high levels of satisfaction with the nation's overall economic situation. This is not surprising considering that the economic indicators most directly affecting the public have improved steadily for at least four years. The national unemployment rate, which peaked at 10.6 percent in December of 1982 has fallen to 6.5 percent; in many East Coast metropolitan areas unemployment is below 4 percent. Helped by the weakening of OPEC, the double digit inflation of 1979 and 1980 slowed to 3.9 percent in 1982 and 1.1 percent in 1986. Nominal mortgage interest rates fell from 15.1 percent in 1982 to 9.3 percent in March 1987, while new auto loan rates dropped from 16.2 to 9.2 percent over the same period. Average personal income tax burdens fell by roughly one-seventh between 1981 and 1986 and will drop further in 1987 and 1988.

Despite the good economic news, the public feels a sense of unease and wonders whether the current situation can be sustained. Taken together, issues relating to the economy—such as unemployment, the deficit and trade—continue to top the list of the national problems that concern Americans.

An overwhelming majority of the public considers the budget deficit to be a very serious problem. While this has been true for several years, there are new indications that Americans are becoming more realistic about the steps that must



Robert D. Reischauer

The window for meaningful deficit reduction may be gradually closing.

be taken to solve this problem. Suggestions that the deficit can be eliminated by reducing fraud, waste and abuse in government programs or by pursuing tax evaders in the underground economy have lost their appeal. While the public continues to oppose (by almost a three to one margin) tax increases to reduce the deficit, a majority now feels that the President should reach a deficit reduction compromise with Congress even if this results in a tax increase. A majority also expects its taxes to rise when the deficit is reduced.

While people in the United States may be more willing now than in recent years to accept a serious attempt to reduce the deficit, the political environment makes it increasingly difficult to forge such a plan. With both the Senate and House under Democratic control, budget policy has inevitably become more partisan than it was when moderate Senate Republicans defined the Congressional consensus. Democrats feel compelled to differentiate their budget proposals from the bipartisan plans of the past. Senate Republicans no longer feel responsible for coming up with a budget plan of their own; now they can sit on the sidelines and criticize Democratic proposals to

cut defense spending or raise taxes. The Senate Minority leader, Robert Dole, concerned about his support among conservatives in the 1988 Presidential primaries, could be reluctant to cooperate with the Democrats on any deficit reduction effort that has not been endorsed by the President.

When the Republicans lost control of the Senate, Democrats were stripped of a useful shield that they had relied on to fend off the demands of their traditional constituents. No longer can Democrats argue that increased social spending won't be acceptable to the Senate; no longer can they reason with these interests that a ten percent reduction in some cherished program should be accepted in order to avoid a Senate attempt to cut the program by 25 percent.

The more partisan deficit reduction measures coming out of Congress will be less acceptable to the White House than were past budget bills and the President will feel less obligation to approve them. Past deficit reduction legislation was formulated largely by moderate Senate Republicans, and once the Senate's Republican leadership had put its prestige and muscle behind passage of such legislation, the President's ability to criticize or veto it was constrained. This is no longer the case. The President will no longer lend his own party's Congressional delegation when he accuses Congress of inaction or vetoes a reconciliation bill.

Conflict within the Democratic party will prove to be as big an obstacle to meaningful deficit reduction as interparty disputes, for when it comes to the specifics of deficit reduction

the Democrats will find it extremely difficult to reach agreement. Sharp differences exist within the party with respect to the appropriate level of defense spending and the allocation of defense cuts across weapons systems and other accounts. While a reluctant consensus has emerged around the necessity to raise taxes, there is no agreement about how this might be done. Some favor increased excise taxes on alcohol and cigarettes, but the distributional consequences of such increases are of considerable concern. Moreover, realistic excise-tax increases will not generate the amount of added revenue called for in the Democratic budget resolutions. Others support higher energy taxes but such proposals bring out the sharp regional differences that exist within the party. Energy taxes also would have inflationary consequences that many Democrats want to avoid. Still others advocate an increase in the top marginal income-tax rate or a delay in the tax cuts enacted in 1986; but the President would surely veto any legislation tampering with tax rates.

The window for meaningful deficit reduction may be gradually closing. As the year progresses, increased inflation and higher interest rates could erode the public's sense of confidence and reduce its willingness to accept the painful actions required to reduce the deficit. The political climate could also deteriorate as 1988 approaches and various candidates position themselves for the presidential race. Once the presidential primary season begins, little progress will be made on the deficit until a new President is inaugurated in January, 1989.

Monetary Policy

James Tobin

April of 1987 may prove to have been a critical turning point in U.S. monetary policy, less dramatic than the Federal Reserve's well-publicized moves in October, 1979, and August, 1982, but quite consequential. The Fed, keeping its discount rate unchanged so far, has underplayed its apparent shift to tightness. But the Federal Funds rate, which is under its control, has recently risen about half a point, perhaps more. The prime and long-term interest rates have gone up a full point. The rising difference between yields on long- and short-term securities suggests that the market now has firmer expectations of further tightening of money and credit.

Nothing in the domestic economic picture gives cause for such a shift in policy. Performance and prospects for 1987 look like more of the same stable and sluggish growth the Fed felt comfortable accommodating for three years and, according to its February Monetary Report, this year too. In particular, domestic sources of price acceleration remain quiescent, with money, wage rates, and unit labor costs actually falling in the first quarter. Inflation reports are not as low as in 1986, but we cannot expect to have energy prices fall 20 percent every year.

Evidently the Fed is "defending" the dollar, and for two reasons. One is fear of inflation as higher dollar prices of internationally-traded goods enter U.S. price indexes. The other is fear of the effects of further dollar depreciation on the economies of Japan and Europe. Neither is convincing.

A U.S. current-account deficit of $3\frac{1}{2}$ to 4 percent of GNP is not sustainable. Although the high value of the dollar during 1982-85 is not the only cause of the international deficit, further real depreciation seems essential to its correction and is certainly much more efficacious and acceptable than the protectionism and commercial welfare rising from national frustration with bilateral trade imbalances. Correction cannot occur unless and until foreign goods become more expensive. That will cause some one-shot increases in U.S. price indexes, but in the present circumstances it is unlikely to trigger a continuing price-wage-price spiral. Now is as good a time

James Tobin

Further real depreciation of the dollar seems essential.



as we are likely to have, short of full-blown recession, for taking the medicine.

Paul Volcker has said that the contractionary impact of further dollar depreciation on the Japanese and European economies would damage our trade balance more than the depreciation would help it. That the secondary effects would exceed the primary impact is a fallacy—if so, the initial contractions of those other economies would also be reversed! Anyway, Japan and Germany, with negative inflation and near-zero real growth, have plenty of room for domestic fiscal and monetary stimulus, on which we should continue to insist. One way or another, they too will have to learn to live without the present trade imbalance.

Present international interest differentials already allow for significant further dollar depreciation, which the Fed may not be able to prevent except by raising U.S. rates enough to spell recession here. The current-account deficit itself throws a heavy stream of dollars into the markets, and the worries of investors about the future value of the dollar may outweigh short-run interest arbitrage. If tight money adds the United States to the company of depressed advanced democracies, it will also harm other economies, not least the debt-ridden Third World.

The Federal Budget

Gail D. Fosler

In recent months, the notion that the federal deficit is finally declining—even without significant additional policy action—has taken hold. That notion should be reexamined. There is a possibility, even a distinct probability, that the federal deficit will not decline in FY1988. To the contrary, the deficit could actually rise from FY1987 levels.

There are two important realities governing the budget process this year. First, there is no consensus on national direction, reflected by the polarization between the White House and the Congress on budget issues. Second, there is a profound disinterest in budget issues generally and the deficit in particular.

The outlook for the remainder of FY1987 and for FY1988 is for very little in the way of policy change to reduce the budget



Gail D. Fosler

A profound disinterest in the budget.

The Revised Chiles Democratic Budget

Many new spending initiatives that would increase budget authority above a "freeze" are being discussed currently. These include:

- Education programs increase by \$2.2 billion, plus an increase for Head Start of \$0.2 billion.
- Job programs climb \$700 million.
- \$400 million in increased assistance to the growing number of homeless individuals and families.
- A \$150 million increase for EPA programs and for land acquisition.
- Increases of \$1.3 billion for space and science programs, including NASA, the National Science Foundation, and the Department of Energy.
- A \$150 million child-care initiative.
- A \$200 million Medicaid initiative.
- Increases of \$150 million for WIC.
- A \$900 million increase for the National Institutes of Health and AIDS research.
- Increases of \$400 million for law-enforcement and judiciary programs.
- Increases in Federal grant assistance to state and local governments by about 5 percent annually, compared with the President's increase of less than 1 percent yearly.
- Funding provided for the election financing reform.
- Aggressive new initiatives to combat drugs and extend anti-drug education.
- Funding for catastrophic health insurance.

deficit, with the exception of continued restraint on defense. There is, however, little real willingness actually to cut the defense budget.

Significant new spending programs will, however, be authorized (see box). This will place substantial new pressure on appropriations. Indeed, new programs will be in hot competition with the budget deficit for revenue sources as the evolving relationship between the cigarette tax and health-care benefits clearly shows.

In short, if the deficit does go down, it will be macroeconomics in general and inflation in particular that will do the job. My best estimate for the FY1987 deficit is still \$175-180 billion. But, for FY1988, the deficit could rise to \$180-195 billion. This would leave the budget deficit in the 3.5-4 percent of GNP range until near the end of this economic cycle.

The Budget Outlook: Policy and Politics

The budget for FY1987 is subject to many risks but, even so, it is unlikely that the FY1987 deficit will exceed \$185 billion and is more likely to be in the \$175-180 billion range. These estimates contrast with estimates of \$190 to \$200 billion that are common on Wall Street.

The Senate will pass a budget resolution for FY1988 this week. It will call for more than \$18.5 billion in new taxes, fund both defense and nondefense discretionary programs at about current policy levels, and contain few spending cuts with the exception of \$3.3 billion in Medicare, about \$1 to \$1.5 billion in agriculture, and \$1.2 billion in federal pay and travel. After it goes into conference with the House, the defense level will be reduced, as will be the cuts in Medicare, agriculture and pay.

The extent to which the FY1988 budget process is governed by either politics or policy will be determined later in the reconciliation and appropriations processes. Reconciliation, including tax increases, and any defense appropriations bill are likely to be held in abeyance until the President has signaled that he will sign one in order to obtain passage of the other. The

President, for his part, is likely to attempt to influence the appropriations process to obtain an acceptable defense level while opposing a tax increase. If a new sequester process is in place, the issue will be joined on September 1, 1987, when the President is confronted with the sequester order.

Given the muddled policy outlook and the prospect for confrontation, it is easy to conclude that nothing of substance will be done to reduce the FY1988 budget deficit. On the tax side, the revenue increases in the budget resolution are almost as large as the tax increase enacted in the Tax Equity and Fiscal Responsibility (TEFRA) tax bill in 1982. Even on defense, the final appropriations bill is likely to contain more reprogramming and payment delays but little in the way of real spending cuts.

Without policy action, the FY1988 deficit is currently projected to be \$171 billion or just \$5 - \$10 billion lower than the projected FY1987 deficit. However, there are a number of items that might raise that estimate. First, it is difficult to imagine a set of economic circumstances that would raise nominal GNP in FY1988 relative to current estimates (\$4698 billion). Nominal GNP is already running \$30 billion or so below the FY1987 estimate. Even better second-quarter growth

is not likely to make up for the shortfall in GNP to date. This would lower the overall revenue base in FY1988.

Second, it is entirely possible that tax reform may raise more revenue in FY1987 but less revenue in FY1988. FY1987 was to benefit from both additional capital-gains payments and from the receipts from the retroactive elimination of the investment tax credit. These revenue sources will not be available in FY1988, when it is possible that the revenue loss from the new depreciation rules will be greater than first thought.

The third item is interest rates: While the interest-rate increase is not a significant issue for FY1987, it is extremely important for FY1988. Ninety-day Treasury-bill rates are currently about 20 - 50 basis points above the 5.5 - 5.8 percent rate projected over the next six quarters. Most note and bond rates are 100 - 130 basis points higher. Rates at current levels would add \$6 - 7 billion to outlays.

For all these reasons, it is possible that the baseline projection of the FY1988 deficit could rise by \$15 to \$20 billion—which, at \$185 - \$190 billion, could put it above the FY1987 level. Under these assumptions, the budget deficit would be mired at about 4 percent of GNP—as the economy begins to head into the late stages of the economic cycle.

The Fiscal Transition

Alan S. Blinder

My assignment is to discuss the broad contours, rather than the nitty-gritty details, of the outlook for fiscal policy. I can summarize my message in five simple statements.

(1) We are, at last, in the early stages of the long-awaited transition to smaller federal budget deficits.

(2) The current deficit reduction path, if maintained for another two or three years beyond fiscal 1988, will bring us to a sensible level of the federal deficit—say \$70-\$80 billion.

(3) If and when we get there, it should not be that difficult to rebalance exports and imports—say, by 1990 or 1991.

(4) During the adjustment period, however, U.S. domestic demand will have to grow about 1 full percentage point slower than U.S. GNP.

(5) To make this all work, monetary policy will have to take up the slack created by fiscal policy. If monetary policy is tightened prematurely, or if political stalemate once again blocks the fiscal transition, all bets are off.

After adjusting the budget to eliminate the distortions of high unemployment and inflation, it becomes clear that, despite all the fuss and bother about controlling it, the deficit grew steadily through 1986, the first Gramm-Rudman-Hollings year. Through fiscal 1985 this was no surprise, as the

Alan S. Blinder

Domestic spending will have to grow slower than GNP.



administration continued its pie-in-the-sky attitudes and belief in puberty economics (you can grow your way out of any problems). Fiscal 1986, however, was a big disappointment, since by then the political consensus for deficit reduction seemed to be in place. The good news, however, is that real progress has been made in fiscal 1987—even if, as I assume, the deficit comes in \$17 billion worse than the administration's forecast.

The emerging bipartisan consensus for a deficit reduction of about \$36 billion in fiscal 1988, if realized, will be the second straight reduction of roughly that size in the high-

U.S. Saving and Investment
(Billions of dollars, National Income Accounts basis)

	<i>Budget deficit (all governments)</i>	=	<i>Investment less saving (private sector, domestic)</i>	+	<i>Net foreign balance</i>
1980	- 35		- 41		13
1981	- 30		- 35		11
1982	-111		-110		- 1
1983	-129		- 90		- 34
1984	-102		- 13		- 91
1985	-136		- 26		-115
1986	-142		+ 6		-143
1991 Target I	- 20		- 20		0
1991 Target II	- 20		- 40		20

Note: Excludes statistical discrepancy.

employment, inflation-adjusted deficit. The historical norm for this budget concept for over 20 years prior to Reagan was a deficit of zero. So, we can balance the budget in the economically relevant sense, *if* we continue on this path for another 2-3 years.

If we bear this in mind, the accompanying table shows a particular arrangement of what by now must be everybody's favorite equation relating saving and investment, the budget deficit and the trade deficit. It goes through 1986, which was the worst year for the budget deficit and, we hope, the biggest year for foreign borrowing. What these numbers show is that during 1982 and 1983, we financed the budget deficit by having a weak economy—which generated a large surplus of private savings over investment. But then, as the economy recovered, the savings surplus fell and we had to borrow from abroad.

Now let us speculate about 1987. Suppose the budget deficit drops by \$18 billion, and the private-sector saving investment balance returns to its 1985 value. (For that balance to recur, the abnormally low personal savings rate of 1986 will have to change.) Then our net foreign balance should improve by

\$40-\$50 billion. That's an optimistic assessment, compared with other forecasts I've seen.

What about a target for 1991? Suppose we succeed in getting the federal deficit down to \$70-80 billion, as suggested above. If the state and local surplus remains around \$60 billion, the total government budget deficit is no more than \$20 billion. As we look at the table it is clear that a private investment saving balance of only minus \$20 billion (Target I) is enough to be consistent with zero foreign borrowing. A more normal investment-saving balance of minus \$40 billion (Target II) would be consistent with plus \$20 billion in the net foreign balance. Thus, if the fiscal transition works, we can meet our international obligations without another recession.

Making this transition without recession, however, requires cooperation from monetary policy. Recent pledges (and actions) to push up interest rates do not bode well for the future. Furthermore, to swing our trade around by about \$150 billion in 1982 dollars, domestic spending in real terms will have to grow about 1 percent per year slower than GNP for about four years. Americans, I'll predict, won't like that. Neither will the next occupant of the White House.

In Europe: Steady as She Goes

Eduard J. Bomhoff

Economic growth in the Common Market area has been very stable since 1983. Both in the European community as a whole and in its most important component, West Germany, economic growth has moved within a very narrow range. Forecasts for 1987 are for a continuation of moderate growth at a rate somewhat below the average for 1984-1986, assuming that the negative effect of the appreciation of the EEC currencies is more important than the stimulative monetary policy in Germany and the United Kingdom. Thus economic growth in Europe will not deviate far from 2 percent during 1987. Indicators of consumer confidence confirm this view. The indicators deteriorated somewhat during the final month of 1986 and in early 1987, but certainly not so extensively that consumers seem to be forecasting a recession. Generally speaking, domestic demand is substituting to a considerable extent for losses in the export markets.

The German central bank will be under tremendous pressure to increase money growth in Germany as we approach the 1988 U.S. Presidential elections, but inflation in Germany seems unlikely to increase beyond 2 to 3 percent. Because economic policy is more volatile in the United States than in West Germany, the dollar-Dmark exchange rate is primarily a function of what happens in the United States. There is no doubt that U.S. authorities are putting enormous pressure on the Bundesbank to inflate, both to promote economic growth in Germany, thus stimulating U.S. exports to Western Europe, and to prevent a further decline in the dollar. Compared with other central banks, the Bundesbank is quite independent and seems unlikely to throw away its reputation as a supplier of low and stable inflation. Thus, I expect the Bundesbank to continue its current stimulative monetary policy, but not to the extent that inflationary expectations in Germany are allowed to rise substantially beyond their current low values. Accordingly, there seems to be no reason to forecast any large changes in German long-term interest rates. Short-term interest rates will always be a function of movements within the European monetary system, but the general tendency has been for the German mark to become stronger after each currency

Eduard J. Bomhoff

Big government is unpopular throughout Europe.



realignment. A reasonable forecast, therefore, would be for slowly declining or at least stable long-term interest rates and no spectacular movements at the short end.

Big government is unpopular throughout Europe, and there seems to be little political pressure for more government spending. The exceptions are training programs for the long-term unemployed or for unemployed young people and investment in infrastructure. True, unemployment remains high by any standard, but public opinion does not seem to believe that either expanding government employment or increasing subsidies to unprofitable firms are appropriate mechanisms for dealing with structural unemployment. Furthermore, European policy makers tend to attach less weight to the effects on economic growth of short-term changes in government expenditure than do their U.S. counterparts. Unemployment is (correctly) regarded as a long-term problem that requires changes in labor market institutions, marginal tax rates, or industrial policies, rather than injections of government funds. The political climate has changed considerably since the late 1970's when a lower level of structural unemployment was attacked in many countries with a combination of subsidies to firms and more direct government outlays. Thus if policy stimulus is to be instituted in Europe, it is more likely to come through planned reductions in tax rates than from higher government expenditure.

Can the U.S. Economy Sustain its Trade and Budget Deficits?

Eric J. Kruger

Are the U.S. budget and trade deficits finally shrinking? Recent evidence suggests that the huge U.S. merchandise trade deficit may have peaked at \$170 billion in 1986. The official dollar-denominated trade data do not yet reveal this trend; but measured by volume, exports are rising and imports are growing more slowly. This trend will continue because import prices are finally showing some increases.

While the low dollar is helping U.S. exports to recover, this does not mean that it will significantly reduce the nominal U.S. trade deficit. Many U.S. exports are not price (and therefore exchange-rate) sensitive. About 50 percent are sold to countries whose currencies have not appreciated against the dollar. Many U.S. exports lack competitiveness for reasons other than price. Similar "non-effects" are visible on the import side, notably consumer price insensitivity and price reductions by foreigners offsetting exchange-rate increases.

Moreover, there has been a moderate increase in real U.S. growth in 1987-88 relative to its major partners increasingly visible in export- and investment-led U.S. expansion. This increase may well lead to an increase in imports relative to exports—especially in consumer products—and a resumption of growth in the U.S. merchandise trade deficit from its trough of \$150-160 billion by the end of 1987.

Aside from the weak impact of exchange rates and the strong impact of cyclical forces on the U.S. trade deficit, there are two other, more powerful reasons why the U.S. merchandise trade deficit is unlikely to be reduced. The first is the decline of markets in developing countries with large external debt and in the oil-exporting countries, which absorbed 40 percent of U.S. exports until the 1980's. The second is the structure of the U.S. economy relative to that of its major trading partners. This latter factor is critical in explaining why the trade deficit is likely to be a persistent feature of U.S. economic life. The United States is now predominantly a services-producing economy. It is also affluent and large, consuming more goods than it produces. The huge U.S. trade deficit in goods does not in and of itself present a problem for the national economy (which is not to say that competition from imports does not present individual U.S. manufacturers and their workers with difficulties).

What is at issue here is the capacity of the U.S. to pay for this deficit, whether by goods, services or income inflows. The real problem is the woefully insufficient net U.S. sales of services overseas and net U.S. earnings from overseas investments. These are approaching zero or even negative themselves, and thus are unable to pay for the deficit in goods. In fact, for the first time in recorded history, the U.S. current account deficit in 1987 may exceed the U.S. trade deficit.

The U.S. budget deficit has probably peaked at \$200 billion in fiscal 1986. But again, the fact that it has peaked should not lead us to expect that it will decline rapidly and durably. Prospects of continued slow economic growth in 1987-1988



Eric J. Kruger

The two deficits are likely to be with us for the foreseeable future.

mean that tax revenues will only increase moderately. The 1986 Tax Reform Act, far from being revenue-neutral, may actually lead to lower actual net revenues than would otherwise have occurred. Tax increases appear out of the question until after the next elections.

On the expenditure side, Congress and the Administration are unlikely to be able to agree on any further cuts. The recent rise in prices and interest rates will compound the difficulties of containing outlays through at least 1988. One is led to the conclusion that the large U.S. budget deficit will not drop to \$135 billion as hoped, but will remain at around \$200 billion, leaving it a major feature of the economic landscape for the next few years. A further decline in the U.S. growth rate, not to mention a recession, would of course cause the budget deficit to grow again.

A government can continue to borrow from its own people indefinitely, as long as it does not draw down its long-term growth potential in the process. Similarly, a goods trade deficit can be afforded if other ways are found to pay for it: most households, neighborhoods and cities that specialize in services have huge goods trade deficits, but pay for them through the sale of their services and income from capital. The problem is that the United States is meeting its shortfalls from foreigners. Indeed, the United States is overconsuming both capital and goods from overseas.

The excess of U.S. federal expenditures over revenues, the net borrowings by U.S. business for investment, and the excess of private consumption over domestic production are linked developments. The U.S. current-account deficit is an inevitable result of these excesses. Any long-term significant reduction in this deficit cannot occur without a contraction in the net inflow of foreign capital, which cannot occur without a drop in the budget deficits and a rise in the flow of U.S. savings to finance U.S. investment.

Since, as has been argued, the two deficits are likely to be with us for the foreseeable future, the United States emerges as utterly dependent upon foreigners' willingness to invest in its private sector and lend to its government. In this context,

the nation faces two key problems. First, its attractiveness to foreigners is in danger of being impaired by its growing indebtedness. Consumer, corporate and government debt are all rising in absolute terms, relative to GNP and, in some cases, relative to equity. Second, the scope of its policy instruments is increasingly limited. Fiscal policy is nearly paralyzed because of the budget deficit. The scope for monetary policy is increasingly circumscribed because of low growth, LDC debt and the independence on foreign capital. And the U.S. is approaching the limits of exchange-rate manipulation.

In these constrained circumstances, the low growth rate of the United States raises the key question of how long the country will remain attractive to foreign investors and lenders. A partial answer can be found in recent history: Despite its two massive deficits, the U.S. economy has kept growing, slowly but progressively, in an expansion that bids to become the long-

est in the post-WWII period. Furthermore, despite these deficits, the United States has managed to remain attractive to foreign capital. The low dollar is seen as impairing this attractiveness for foreign investors, particularly the Japanese, but most of the time there is no place other than the States that can accommodate the scale of Japanese capital. Moreover, foreign direct investment here is currently a global bargain, as reflected in growing net investment flows into the United States.

It is my belief that the United States will be able to sustain its two huge deficits and remain attractive to foreigners, provided its growth rate and rates of return on investment, at home and overseas, are sufficient to pay foreigners net interest and a return on their investments. This issue, much more than the size of the trade deficit or the budget deficit, is where policy and private-sector attention must focus.

Prices, Pay, Profits and Productivity

Geoffrey H. Moore

Cyclical upswings and downswings in the rate of inflation have long been an important factor in U.S. economic experience. Between 1949 and 1980, we had six upswings in inflation that lasted more than a year, each followed by a downswing. The latest downswing began in March 1980, when the rate of increase in the consumer-price index reached 15 percent. It seems to have ended in April 1986, when the rate got down to one half of 1 percent. Since then it has climbed to 3.9 percent as of March 1987. (The growth rates referred to throughout this report are six-month smoothed percent changes at annual rate, based on the ratio of the current month's index to the average index over the preceding twelve months.) I am inclined to classify this as a new cyclical upswing, comparable with the preceding six upswings.

Inflation cycles are not as well known as business cycles, and certainly they are not independent of business cycles. Nevertheless, they do have characteristics of their own, and even have their own leading indicators. So I think it is worthwhile to look at the current situation with regard to the four P's—prices, pay, profits and productivity—in the perspective of previous inflation cycles. This may help answer the question of where we go from here.

The consumer-price inflation rate (see chart) has been tracking the previous average upswing quite closely, but has been rising somewhat faster than the average. Partly, at least, this reflects a recovery from the low levels of gas and oil prices last spring and summer. When energy prices are excluded from the CPI, the March growth rate is 4.3 percent but its rise to that point is less dramatic.

Geoffrey H. Moore

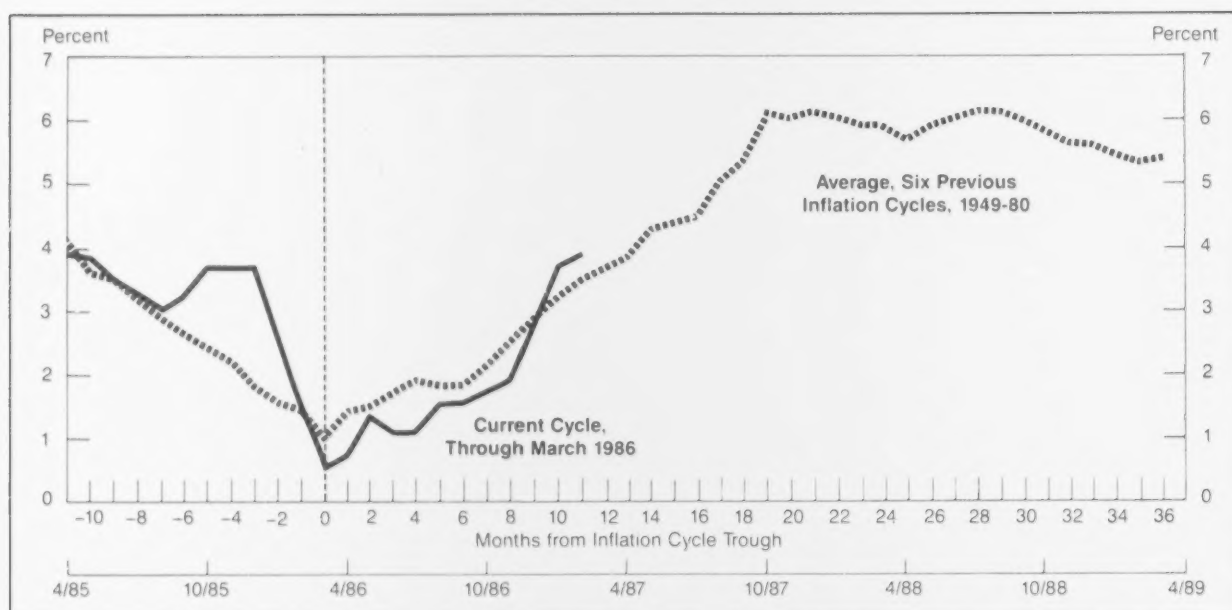
The outlook is moderately upbeat.



The producer-price index growth rate started its upswing at the same time as the CPI rate, as it usually does. It rose from a negative rate of -3.9 percent in April 1986 to a positive rate of 2.4 percent in March 1987. The March rate is below the average for the previous six inflation upswings, but the gap is narrowing.

The survey of prices paid by members of the National Association of Purchasing Managers, now available through April, indicates that buyers of materials and supplies for their companies are well aware of the rising inflation rate. The Journal of Commerce daily index of industrial materials prices clearly supports this view. As of May 1st its annualized growth rate was 21.7 percent, higher than at any time since 1979. The acceleration has been widespread among the 18 industrial materials included in the index. As of May 1st the annualized growth rates in the three sub-indexes were: textiles, 15.8 per-

Rate of Change in Consumer Prices Inflation Cycle Pattern



cent; metals, 8.8 percent; miscellaneous (including crude oil), 33.9 percent.

The leading inflation index calculated by the Center for International Business Cycle Research also has been moving up, starting from its low in September 1985, seven months before the low in the CPI rate. The rise has been more subdued than the six-cycle average pattern, but so far there has been no indication of a reversal.

A considerable portion of this inflationary upswing is due to the decline in the dollar and its impact on import prices. The advance in the growth rate of import prices, excluding fuels, dates from the first quarter of 1985, when the dollar exchange rate began to fall. Since early 1986 import price growth rates in the 7 to 10 percent range have prevailed.

Labor costs per unit of output in nonfarm industries have in the past been a lagging indicator of inflation, with the growth rate in costs beginning to rise some six months or so after the CPI rate turns up. The fourth quarter showed some acceleration in these costs, but this was reversed in the first quarter, so the lagging tendency still prevails.

The modest increases in unit labor costs have been the result of almost equally modest increases in hourly compensation and even smaller increases in productivity. In previous inflation upswings, a speed-up in pay rates has been offset in part,

but only in part, by a speed-up in productivity. So far, neither of these trends has appeared.

We come then to the bottom line. Profit margins usually move up in the early stages of an inflation upswing. So does the ratio of price to unit labor cost, which is a proxy for profit margins. That is to say, selling prices advance more rapidly than costs of production. The available quarterly data do not show much evidence that this has happened so far in the current upswing. But we have recently constructed a new monthly price/labor-cost ratio for manufacturing, and this shows that prices have advanced somewhat faster than unit labor costs since March, 1986.

With regard to the future, my view is that the upswing in the inflation cycle will continue at least through 1987, with the Consumer Price Index in the neighborhood of 5 percent by the end of the year. This view is supported by the leading index of inflation, which has been spurred by rapid increases in materials and import prices. Pay increases are likely to react to the more rapid advance in living costs, with 4 and 5 percent adjustments becoming more common. As for productivity growth, my guess is 2 to 3 percent for 1987. Some advance in profit margins is consistent with these figures, especially since I do not regard a recession as imminent. In short, the outlook for prices, pay, profits and productivity is moderately upbeat.

Consumption and Housing

Jason Benderly

Worries persist about the consumer's ability or willingness to keep increasing expenditures. Such concerns are rooted in a variety of considerations, including an historically low saving rate, a debt level regarded by many analysts as too high, and more recently, prospectively anemic income growth and concern that financial-market instability will shake consumer confidence.

A review of the evidence suggests that fears of a major consumer retrenchment are unfounded. The growth rate of real personal consumption expenditures should slow from 4.0 percent in 1986 (fourth quarter to fourth quarter) to a 2.0 percent to 2.5 percent in 1987, a rate more in line with, but still slightly above, underlying income growth.

Total real expenditures have declined for two consecutive quarters at a 0.4 percent annual rate, but this does not signal the beginning of a retrenchment. Expenditures, except for autos and trucks, have increased at almost a 3.0 percent annual rate over the past two quarters and, importantly, are still increasing at least at that rate early in the second quarter. An even stronger growth rate emerges if an unusual decline in energy consumption is excluded from consumer expenditures: the growth is real outlays on items other than motor vehicles and energy actually accelerated in the first quarter to a 5.3 percent annual rate from 2.0 percent during the second half of 1986 (see table). The justification for isolating these two components is twofold: First, they are currently subject to transitory influences—the timing of auto financing and sales tax incentives, unusually warm weather during the winter, and a sharp increase in retail energy prices. Second, cutbacks in expenditures on these items have generally not given rise to an offsetting increase in spending on other goods and services.

The conclusion that can be derived from this analysis is that

Jason Benderly

Fears of a major consumer retrenchment are unfounded.



a growth rate somewhere between 3.0 percent and 5.3 percent is a more appropriate gauge of consumer behavior in the first quarter than the 0.4 percent decline in total expenditures. In fact, the notion that underlying consumption picked up in the first quarter is actually more consistent with how consumers typically would react to the \$25-billion cut in personal income taxes, which added about 3.3 percentage points to the growth in first-quarter real disposable income. Over the year, in fact, much of the 2 percent income in real income is attributable to tax reform and farm subsidies. An outlook for a continuation of about 2 percent real income growth over the balance of 1987 depends on a slowing of consumer inflation to about a 4 percent annual rate, a 3 percent to 4 percent growth rate of compensation per manhour, and employment growth at a 2 percent to 3 percent rate.

The historically low level of the personal saving rate should not be taken as evidence that consumers will necessarily attempt to rebuild their savings. A significant determinant of

Real Personal Consumption Expenditures

(percent, at annual rates)

	1983- 1986	1986			Estimated			
		1st half	2nd half		1987			
					I	II	III	IV
Total	4.2	4.9	3.1	-0.4	4.5	2.6	1.9	
Durables	9.9	5.9	13.5	-17.5	14.0	5.0	0.0	
Nondurables	3.1	7.2	-0.5	1.2	3.0	2.5	2.0	
Services	3.5	2.9	2.8	4.3	2.0	2.0	2.5	
Autos and trucks	11.8	6.0	13.9	-44.8	35.0	10.0	-5.0	
Energy	2.6	6.2	8.6	-20.7	5.0	2.5	2.5	
All other	4.0	4.7	2.0	5.3	3.0	2.2	2.0	

Sources: Bureau of Economic Analysis; Goldman Sachs Economic Research

the personal saving rate has always been household wealth or net worth, and the current 3.5 percent saving rate is in line with aggregate net worth.

The reported stock of consumer installment debt as a percentage of disposable income is terribly misleading as a measure of consumer indebtedness. In general, the ratio of debt to disposable income is determined by five variables:

- the propensity to borrow (defined as the ratio of new loan extensions to disposable income);
- the rate at which loans are prepaid;
- the maturity of those loans;
- the interest rate charged; and
- the growth of income.

Of the five, only the first two can properly be characterized as behavioral in nature. The others may affect behavior by altering propensities to borrow new funds or prepay loans; quite independently of those effects, however, they can influence the debt/income ratio in a purely mechanical way.

A carefully constructed time series of the ratio of debt service to personal income, i.e., the monthly burden of servicing the existing level of installment debt, shows a declining secular trend, in contrast to the rising trend of the debt-to-income ratio. The primary but not sole reason for the divergence is the increasing maturity of most forms of consumer credit.

The newest concern—that increased financial-market instability will lead to a decline in consumer confidence—is difficult to assess quantitatively. As a general rule, if increased

instability is going to deter spending, it must first affect some aspect of consumer expectations that bear directly on spending decisions. This would include declining expectations of job opportunities, deteriorating expectations of future personal finances, or expectations of rising interest rates. Unless the volatility in the bond or foreign exchange market causes a deterioration in these expectations, it is not likely that consumer spending will be materially affected. In addition, the rise in interest rates to date is not large enough to cause a significant decline in the path of expenditures.

Housing

The demographics for housing imply an underlying annual demand for about 1.7 million housing units. That figure is derived from the estimated 1.50-1.55 million unit growth in households plus an additional 150,000-200,000 units of demand from several miscellaneous sources. New home sales are currently running in the 650,000-700,000 range, which suggests single family starts of about 1.2-1.3 million units. High vacancy rates and tax reform are taking their toll on the multi-family sector, the result being about a half million unit rate of construction. Total starts are therefore in the 1.7-1.8 million unit range, but only for the time being. A lower level of mortgage rates mostly affects the timing of home sales and starts, not the average level over a full cycle. Starts above 1.7 million are essentially borrowing from the future, and it should thus be expected that starts will decline to somewhat below 1.7 million sometime later this year.

Outlook for Inventories and Capital Spending

Adrian T. Dillon

The role of inventories in the economic outlook has been the subject of some concern and controversy. Reducing the overhang of inventories accumulated in 1984 subtracted 1.2 percentage points from the economy's growth in 1985 and another 0.1 percent from last year's GNP growth. This year is supposed to be a different story: With economic growth continuing at a moderate pace and net exports beginning to turn around, renewed inventory building has been expected to add half a percent to total 1987 GNP growth.

The question is whether that accumulation had already occurred by April. Nonfarm inventory investment reached \$27.7 billion in the first quarter of 1987; versus a drop of \$9.8 billion in the fourth quarter of 1986. Thus, the change in inventories added \$37.5 billion to the first quarter's growth, or virtually all of the 4.3 percent growth rate in real GNP. The concern is that this rapid rise in inventories has been unexpected and excessive, and suggests that from this point forward inventories will be a source of weakness rather than strength in the outlook.

I believe that this interpretation of the inventory situation is incorrect, primarily because all of the buildup in inventories in the past quarter essentially occurred in one industry: autos. Excluding the auto buildup, inventories contributed only 0.2 percentage points to first-quarter growth. In fact, as a ratio to sales, both nondurable and durable goods inventories continued to decline in the first quarter, falling to the lowest levels since the early 1960s.

As we look ahead, the contribution of inventories to the economic expansion during the remainder of 1987 and 1988 should remain moderately positive. This quarter, Detroit's production will essentially equal sales; other nonfarm inventory investment should rise about \$25 billion, even assuming a further decline in the inventory-sales ratio. Thus, second quarter real GNP growth is very likely to exceed the consensus estimate of a 1 percent advance. The third quarter could show more modest growth as automakers reduce production significantly below sales, but nonfarm inventories should continue to build at a \$20 billion to \$30 billion rate well into 1988. In short, except for autos the inventory outlook is bright. In the aggregate, inventories should boost real GNP growth this year by 0.5 percentage points and add another 0.1 point to 1988 economic growth.

Capital Spending

Over the past couple of years, the performance of capital spending has been dominated by tax reform, the surprisingly weak computer sector, and the collapse of oilfield investment. After rising 9.3 percent in 1986, total capital spending fell 1.1 percent last year. Looking ahead, spending should be up a modest 1 percent this year and a relatively strong 6 percent in 1988. Virtually all of this strength will be in equipment rather than structures, however. Perhaps the best news is that, for



Adrian T. Dillon

Trade begins to turn.

the first time in the 1980's, U.S. producers of capital goods should participate fully in the strengthening in capital-equipment demand as the trade picture in capital goods begins to turn around.

Last year, total capital *equipment* spending (71 percent of total capital spending) suffered from general concern over the impact of tax reform and, specifically, from the loss of the investment tax credit, which pushed early-1986 spending back into 1985. Real purchases rose 4.2 percent last year compared with the 19 percent rise in 1985. Growth of all major categories of equipment spending slowed last year, with information processing rising 4.3 percent compared with a 13.4 percent advance in 1985. Transportation equipment was up 4.5 percent after a 13.4 percent rise, and industrial equipment purchases were up 4.2 percent last year following 1985's 5.8 percent increase. U.S. manufacturers' shipments of capital goods continued to show more sluggish advances than the trend in purchases, with real growth reaching only 2.4 percent last year as the import share of the U.S. market climbed above 30 percent (versus 12 percent in 1980). To date in the expansion, U.S. purchases of capital equipment have risen 25 percent above their previous cyclical peak; U.S. manufacturers' shipments of capital goods, however, have only in the past 6 months reached the peak levels achieved 7 years earlier. In other words, 100 percent of the peak-to-peak increase in capital-equipment demand during this expansion has gone to imports.

Now, however, the outlook for capital-equipment purchases and shipments is brightening. The negative impact of tax reform is largely behind us, while the positive impact of lower corporate and personal tax rates lies ahead. Information processing equipment, 36 percent of total capital-equipment spending, is finally rebounding from 2 years of very sluggish performance, and should be up at least 10 percent-12 percent annually over the next 2 years. Transportation-equipment spending (22 percent of the total) will be flat this year due to a decline in business purchases of autos, but heavy trucks should be up 10 percent and aircraft up 6 percent. Industrial-equipment purchases (21 percent of equipment purchases) have closely tracked the trend in manufacturing, and should

rebound with a 6-9 month lag following the recent improvement in the U.S. industrial sector. After a 2.5 percent increase this year, industrial equipment purchases should jump 6.5 percent in 1988.

For U.S. manufacturers of capital equipment, the prospects are also better. Over the past 9 months, growth of U.S. manufacturers' shipments of capital equipment exceeded the growth of U.S. purchases, as exports jumped at a 15 percent annual rate and imports began to flatten. This year, U.S. shipments should rise nearly 10 percent, beating the forecast (a 5.5 percent rise in total U.S. equipment purchases) for the first time in the 1980's. Next year, U.S. shipments should repeat that performance, rising 11 percent compared with a forecast 8 percent rise in total U.S. capital-equipment spending.

In sharp contrast to the outlook for equipment, the prospects for nonresidential structures (19 percent of capital spending) are poor through 1988. Commercial and office construction was due for a fall because of a 54 percent real increase in building during 1984-1985 that drove vacancy rates

to record levels, above 20 percent. Tax reform hurt all sectors of nonresidential construction by essentially halving depreciation allowances compared with prior law for many categories of structures. The 35 percent decline in 1986 oilfield spending also affected this sector of capital spending, producing an 11.6 percent drop in total nonresidential structures spending last year after an 8 percent rise in 1985.

This year, all major categories of nonresidential structures will continue to decline. After last year's 4 percent drop, commercial and office building should fall 17 percent. The decline in industrial structures, which exceeded 15 percent last year, should reach 9.5 percent in 1987. In the aggregate, nonresidential construction is expected to drop 8.3 percent this year. Looking ahead to 1988, commercial and office construction is expected to fall another 4 percent, but we could see a turnaround in industrial construction. Assuming that manufacturing growth continues to pick up over the next year, industrial construction could rise 5.6 percent in 1988, producing an 0.5 percent rise in total nonresidential construction that year.

Rising Interest Rates in a Challenging Market

Daniel S. Ahearn

The U.S. credit and capital markets are currently struggling with a new and challenging environment. International forces have become much more important. At the same time, the domestic economy and its institutions appear to be behaving differently than they have in the past, so old rules of thumb have become obsolete. And the markets themselves have changed dramatically, reflecting a multitude of financial innovations, rapid changes in the regulatory environment, and a significantly different mix of market participants.

Domestically, an extraordinary volume of monetary growth has been recorded in recent years, threatening but not creating—at least not yet—the inflation that historically has resulted from rapid monetary expansion and big budget deficits. The U.S. budget deficit this year will be much smaller than the fiscal '86 record but many see the improvement as nonrecurring and expect continuing large deficits. The record deficit in the U.S. trade account may have peaked in real terms but is probably still rising in dollar terms. And the extent of additional trade improvement in real terms may be limited by consumer preferences in the U.S. and by the sluggish growth of U.S. export markets abroad.

Meanwhile, the U.S. economy continues to rise at a moderate pace, though in recent weeks a substantial acceleration has appeared in the order books of some major industries, which may presage a significant pick-up in the pace of the general economy. Until recently, a large volume of excess capacity and unemployed labor, plus weakness in the international price

Daniel S. Ahearn

A weakish dollar and a bearish bond market.



of oil, had prevented a pick-up in inflation. But the rebound in oil prices and the decline in the dollar are bringing increases both in prices of imports generally and in prices of domestically produced goods competitive with imports, which has revived inflationary psychology. This is a potentially dangerous development, given a background of high monetary growth, large budget deficits, and an emerging drift toward protectionism, which could aggravate such a psychology. As a consequence, Federal Reserve monetary policy has become somewhat less accommodative in the past few months, despite the monetary authorities' concern about the vulnerable international debt situation and domestic credit problems in the agriculture, energy and real estate sectors.

The markets themselves have undergone great changes in

recent years. Investment bankers have created a host of new instruments of which the most widely known perhaps are the mortgage-backed securities, junk bonds, and zero-coupon bonds. Less well known but equally important and not fully understood are interest-rate swaps, which total in the hundreds of billions. Not all the innovations have worked as expected. Many sophisticated investors have discovered that the hedging techniques they adopted to reduce risk have in fact increased it. It has not been uncommon for investors to lose money on both the hedge and the securities they were hedging.

The participants in our credit markets have also changed substantially. Most obvious, perhaps, is the globalization of markets. Events in Tokyo have become as or more important as events in New York. U.S. investors often find bond price levels substantially changed from the preceding night's close by the next day's market opening, reflecting trades in London or Tokyo. Foreign investors, notably the Japanese, have been supplying \$120 to \$140 billion a year to the U.S. credit and capital markets, equivalent to two-thirds of our federal budget deficit. The Japanese have often bought one-third to one-half of new long U.S. Treasury debt issues. This vastly increased dependence on foreign investors appears to have contributed to the volatility of our markets.

Another important change with potential for increased volatility has been the enormous increase in U.S. bond funds. During the past eight years assets held by bond funds rose from \$14 billion to \$36 billion, or by more than 25 times. Much of the money for this increase came from individuals who were trying to maintain their income as interest rates dropped on money-market funds and similar investments. In effect, these individuals bought into bond funds of longer maturity and lower quality to get a better yield. Anecdotal evidence suggests that many such shareholders are unaware that they are now exposed to capital erosion if interest rates rise or concerns about the quality of assets in junk-bond funds increase. Thus, the risk is rising that increases in interest rates and legal developments in the junk-bond arena might alarm investors and touch off a rash of redemptions. It is too early to say how important this could be but net redemptions of some mortgage-backed securities funds recently rose to 1½ percent of assets per day, similar to what happened to junk-bond funds very

briefly last fall. Persisting heavy redemptions in relatively illiquid sectors such as municipals, junk and mortgage-backed securities could create a liquidity strain that might invite news media attention and thus feed on itself.

With international investors so important to our markets, the outlook for the foreign-exchange value of the dollar has become a key consideration. The 40 to 50 percent decline in the value of the dollar versus the German mark or Japanese yen has not only offset gains in the bond market for Japanese or German investors but also inflicted painful losses during the past twelve months. No one knows at what level the dollar will stop falling against these currencies. If the bottom is believed near, foreign investors might again buy dollar investments more aggressively, rather than hold back. But even in this case, they are likely to prefer equities, real estate, and direct purchases of U.S. companies, all of which might be expected to benefit from the enhanced competitiveness and relative U.S. production advantage that a low U.S. dollar is providing. The lower dollar provides little incentive for foreign buying of U.S. bonds, which can be expected to suffer from the increased inflation, the acceleration in business and its demands for credit, and the encouragement of a less accommodative monetary policy that a lower dollar fosters. At the same time, the huge buying by the bond funds, a phenomenon of the big drop in interest rates, is not likely to be repeated in an environment of flat or rising rates.

Meanwhile, the lower dollar should enhance U.S. competitiveness and stimulate U.S. industrial production. This will increase demand for inventory and other short-term credit. Demand for long funds should also benefit from a lower dollar as the rising profitability of the U.S. economy increases demand for capital investment.

What can be said about the outlook for prices and yields? First, expect continued high market volatility, violent downswings, and somewhat less sharp rallies. Second, if the dollar is fairly weak on average over some years ahead, the bond market is likely to have a bearish trend, much as it had a bullish trend during the years when the dollar *averaged* on the strong side. Third, interest rates and bond yields are likely to be higher in 1988 than in 1987, if business activity and consumer prices continue to rise as I expect.

Outlook for the Equity Market

Edmund A. Mennis

The bull market that started in August, 1982, the second longest since World War II, has some remarkable features. From 1982 until the end of 1986, earnings (as measured by the Standard & Poor's 500 stock price index) increased 16 percent. But the price of that index increased 136 percent, so that the market's price-earnings ratio increased from 8.6 to 16.1 times. From the beginning of 1987 to the market peak on April 6, prices rose another 25 percent and the price-earnings ratio increased to 17.8 times a generous estimate of 1987 earnings. What accounted for this performance?

The primary reason, undoubtedly, was the trend of inflation, which moved from double-digit levels in the early 1980's to just over 1 percent last year. Shrinking inflation had a dramatic impact on interest rates; thirty-year Treasuries fell from a yield of more than 13 percent in mid-1982 to about 7.5 percent recently, and three-month Treasury bill rates fell from more than 9 percent to about 5.5 percent. These lower yields forced many investors to seek the higher returns they believed available in the stock market.

Other factors also helped stock prices. Lower inflation improved the quality of earnings by eliminating the distortions due to inventory profits and underdepreciation. The drastic cost-cutting programs and lower labor costs of many corporations improved profit margins and profit prospects. The supply of stocks also shrank, by more than \$200 billion in the three years 1984-86. Although private pension funds were net sellers of stocks, public-pension-fund and mutual-fund buying more than made up for this. Moreover, last year and especially in early 1987, foreign investors were major purchasers of U.S. equities.

So much for how we got here. It now appears that some snakes have gotten into our Garden of Eden. No one expected the low inflation rates of 1986 to continue, but a number of forces are pushing inflation up more than many had expected, and inflation is not good for price-earnings ratios. In fact, as the experience of the mid-1970s clearly demonstrates, as inflation rises, price-earnings ratios drop sharply. A major problem is the continuing inability to deal effectively with the federal deficit. In addition, in contrast to 1986, oil prices are trending upward, not falling. The massive U.S. trade deficit has caused a depreciating dollar and higher prices for imports, which in many instances are matched by higher domestic prices as well.

An additional effect of a falling dollar is that it discourages foreign investment in U.S. securities. It requires the Federal Reserve to foster higher interest rates and also to engage in substantial efforts to stabilize the dollar in conjunction with other central banks. Rising interest rates not only provide competition for stocks but also increase the probabilities of an eco-



Edmund A. Mennis

A correction now would be far healthier than continued expansion into speculative territory.

nomie downturn that might well expand beyond the United States. In this fifth year of economic expansion, earnings may not rise the 15 percent or more so widely forecast.

Finally, the daily volatility of the stock market has reached a scale not seen before. Investor confidence has been adversely affected by this increasing volatility of security prices, as well as by the insider-trading scandals that have shaken belief in the integrity of the financial markets. Faced with these uncertainties, many investors, foreign and domestic, are having second thoughts, and stock prices are now about 6 percent below their record peaks.

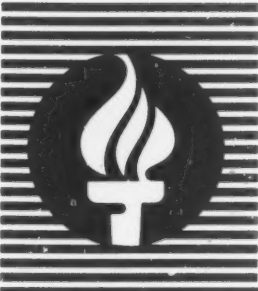
What happens now? The stock market is high by any historical valuation, be it price-earnings ratios, dividend yields or price-to-book ratios. Moreover, some of the factors that sent the market to new highs are beginning to erode. The market seems to have a limited upside potential at this time and, in spite of the recent drop, still seems vulnerable. At current levels, the price-earnings ratio is still 17.4 times a generous estimate of \$17 a share earnings, and the dividend estimate of \$8.40 provides a yield of only 2.8 percent. With these negative factors, a correction now would be far healthier than continued expansion into speculative territory, with the increasing probability of a more severe drop later.

The dimensions of a correction are hard to guess. They would depend on whether the correction begins soon and occurs gradually. Assuming that we have no unexpected shocks, the dollar stabilizes, the U.S. trade deficit improves, the budget deficit continues its downward trend, and inflation is contained in the 4-5 percent range, the longer term outlook for equities could be quite favorable. We could have another prolonged period of good earnings and relatively high multiples, such as we had from 1958-72. That happy outcome could occur later this year and in 1988. But until a significant reduction occurs in these obstacles to economic and profit growth, I find it difficult to take an optimistic view of the equity market.

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Measuring Business-Unit Performance

Managements

- *link evaluations to performance of other companies, industry groups*
- *watch both financial, nonfinancial indicators*

Surveyed Executives Believe

- *measurements have significant effect on results but*
- *can overemphasize the short-term*

Sources of Information

Two sources provided information for this project. The principal one was a questionnaire mailed to the chief financial executives of 400 firms. These companies were chosen from the Fortune 1000 industrial companies and a list of 50 companies in service industries, based on the likelihood that the companies would be organized along divisional, subsidiary, or other business-unit lines. A total of 85 usable survey responses were received, and most of them included lengthy comments and explanations. Telephone interviews with some executives clarified points in the written responses.

Before the survey was mailed, a discussion group was formed to advise The Conference Board on this project. This group consisted of accounting executives from five large, divisionalized companies, a partner from a major accounting firm, and the research director of one of the professional accounting societies. In a meeting with members of The Conference Board's staff, the members of the group helped identify major problems in measuring divisional performance and supplied insights into company practices.

The Conference Board is grateful to the 92 executives who participated in this project for their time, the wealth of knowledge, and experience that they contributed.

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Measuring Business-Unit Performance

by Francis J. Walsh, Jr.

Introduction

The merger and acquisition wave of recent years has drawn attention again to the task of controlling diversified and decentralized business operations. Ever since business enterprises began to move beyond simple one-product or one-location modes of operation, their managements have sought to measure the performance of individual segments.

Major Findings

Efforts to control business units by means of financial measurements go considerably beyond the mere preparation of divisional income statements and balance sheets. Analysis of financial-statement elements, calculation of a variety of rate-of-return indicators, cash-flow analysis, and a number of other measurement techniques are commonly employed in today's decentralized companies.

Despite their widespread use, however, there are no generally accepted standards for calculating most of these indicators. Consequently, senior executives and management accountants custom-tailor selected measurements for their particular companies and circumstances.

Participants in this study repeatedly stressed that no single indicator can be expected to provide a reliable measurement of total performance. Rather, a variety of measurements and trends need to be evaluated together, with the whole exercise moderated by experienced business judgment!

This study identifies the financial performance indicators currently used by a group of leading corporations to assess the performance of operating divisions, or other units, of such companies. (See box on "Sources of Information.") Three types of measurements are most common: (1) income, earnings or profit indicators; (2) rate-of-return indicators; (3) asset and liability management indicators. Within these broad categories, however, lies a variety of individual factors that companies rely on. And each has its advantages and disadvantages, executives report. Financial factors used to administer incentive compensation programs are most likely to be income indicators or rate-of-return measurements. Most companies that participated in the study use nonfinancial

measurements as well, with market share, quality, manufacturing productivity, introduction of new products or services, and sales volume growth cited most often.

Criteria are usually established by a senior-management team, with the chief financial officer playing a key role. Other corporate executives and, in many cases, business-unit managements also participate. The performance of other companies and averages in industry groups are the most important considerations in setting standards. Virtually all respondents believe that performance measures have a significant effect on divisional results. A sizable majority of them also worry that focusing on such indicators can overemphasize the short term.

Problems with Management Accounting

Companies have far fewer rules and restrictions to contend with in setting up their internal management accounting systems than they do in their external reporting practices, which are governed by generally accepted accounting principles (GAAP). Consequently, firms vary in how they allocate costs to their business units. Indeed, in his landmark study of divisional performance measurement, David Solomons observed that it was difficult to prevent such an exercise from "turning into a general examination of management accounting."² Two decades later, the same problem exists. (See Appendix III for a list of helpful references.)

In part this variation arises from different attitudes concerning precisely what a business unit is responsible for. Some managements believe that every expenditure incurred anywhere in the company ultimately benefits the units that produce and sell products. Therefore, they tend to allocate nearly all costs and expenditures to these units. Even where no real basis exists for assigning certain items, such items may be grouped into a pool that is then allocated to units on an arbitrary basis.

Some companies go to great lengths to make their business units (and their related financial statements) as much like in-

¹ Another point to bear in mind, of course, is that comparisons of absolute dollar measurements over time are valid only when inflation rates are insignificant.

² David Solomons, *Divisional Performance: Measurement and Control*. New York: Markus Wiener Publishing, Inc., 2nd Edition, 1985. (Originally published in 1965 by Financial Executives Research Foundation.)

dependent businesses as possible. For example, the chief financial executive of a transportation company describes his firm's efforts as follows:

"We have attempted to capitalize our divisions or business units at levels of debt and equity appropriate to their particular businesses. A management fee is charged for parent-company expense as a percent of division equity (at the same rate for all units). External debt is assigned to the specific units as much as possible, as if they financed themselves externally. We have done all this so that we might rely more on traditional financial measurements." [The company uses these measurements: Income before taxes, return on equity based on after-tax income, return on assets, and asset turnover.]

Other managements believe that it distorts the results when nearly all items of company-wide expense are allocated to business units. They prefer to measure their units on the basis of only those costs for which each unit is directly responsible. Consequently, allocations and reallocations are minimized. Some companies also lean in this direction to reduce the bickering that inevitably arises whenever allocations are made.

There are also differences in how assets and liabilities are assigned to units. Of course, when a plant, for example, produces for only one unit, there is no problem. The difficulty arises when the same plant supplies products for two or more. "Unscrambling the omelet" is a vexing difficulty, and often arbitrary decisions must be made just to get the job done.

Other management accounting issues that affect business-unit performance measurement include transfer pricing, whether done at cost or market, and charging interest on capital.

While management accounting problems are not within the scope of this study, they should be kept in mind when considering its results. The computation of rate-of-return indicators, for example, is strongly affected by allocation policies and practices. And in general, financial ratios of business units should not be compared unless the allocation practices are also comparable.

Problems with Terminology

Business units can bear any number of labels—such as divisions, departments, subsidiaries, lines of business, profit centers—depending on the tastes and traditions of the corporation. Perhaps the most important factor is whether the unit functions as a separate corporate entity or is an unincorporated segment of a larger organization.

In this study, an unincorporated unit will be called a

division, while a separate corporate entity controlled by a parent company will be reported as a *subsidiary*. This distinction seems to be generally observed throughout the business community at this time.

In many decentralized companies, the major operating divisions are known as *profit centers*. The following definition outlines the major features of the profit center:

"The profit center is intended to function much like an independent business. It has four main characteristics:

- (1) It has a defined profit objective.
- (2) Its management has authority to make decisions affecting the major determinants of profit.
- (3) Its management is expected to use profit-oriented decision rules.
- (4) Its management is accountable to higher management for the amount of profit generated.

"The result is that the typical profit center is a division selling a limited number of product lines or serving a specific geographic area. It encompasses both the means of providing goods or services and the means of marketing them.

"Top management is likely to:

- (1) Make all the major decisions on financing and capital expenditures,
- (2) Require that divisions conform to overall company policies, and
- (3) Stipulate that each division's activities be coordinated with those of other divisions.

"Although other restrictions are also common, a true profit center should have at least three kinds of authority within the limits established by company policy:

- (1) Freedom to choose its customers.
- (2) Freedom to choose the sources of supply for most of the materials and other goods and services it buys.
- (3) Authority to decide how many people to use in pursuing its profit goals and how to use them."

Incorporation of business units as subsidiary companies is especially common in international operations, where local laws usually require incorporation in the host country. But home-country subsidiaries also exist. For example, when an acquisition has income-tax losses to be carried forward, its existence will continue at least until the income-tax benefit is exhausted. Also, when an acquiring corporation does not achieve 100 percent ownership of an acquisition, the acquired corporation will continue to exist as a separate corporate entity.

¹ Gordon Shillinglaw and Philip E. Meyer, *Accounting: A Management Approach*, Homewood, Illinois: Richard D. Irwin, Inc., 8th Edition, 1986, p. 843.

Financial Measurements

The 85 companies participating in this study use a remarkable variety of financial measurements to assess the performance of their business units. Altogether, more than 100 financial indicators were cited, although most are variations on a few basic themes. Only six companies rely on a single measure of performance; the vast majority use anywhere from two to sixteen indicators in their internal reporting systems.

Classification of Financial Indicators

Three broad classes of financial indicators make up the majority of those reported by the surveyed companies. They are:

- *Income, earnings, or profit* indicators (mentioned 107 times);
- *Rate-of-return* indicators (mentioned 91 times);
- *Asset- and liability-management* indicators (mentioned 88 times).

Less frequently reported financial measurements include:

- *Cash-flow* measurements (mentioned 53 times);
- *Volume-of-business* measurements (mentioned 50 times);
- *Cost- and expense-control* indicators (mentioned 13 times).

Appendix I presents a detailed analysis of the various classes of financial performance indicators summarized above. As the tables it contains show, usage of various measures is very scattered, even though most are modifications of fairly standard indicators. A substantial number of them appear only once or twice.

Income Measurements

A typical income statement, whether prepared for a corporation or a business unit, discloses several kinds of income—income from operations, income before taxes, etc.—in the step-by-step process of arriving at net income, or “the bottom line,” for the period. That figure is also referred to as “earnings” or “profit,” especially in casual conversation and for internal management reporting purposes. For the sake of consistency, “income” will be used in this report.

The two most common measures found are either simple (or slightly modified) net income or income from operations. Simple net income does not allow much opportunity for variation because it should—even for internal reporting purposes—be determined pretty much in accordance with generally accepted accounting principles. But income from operations can be defined as an individual company’s management see fit. Several surveyed executives explained how this number is derived in their companies:

“Operating income includes:

- (1) Provisions for the pro-rata share of the *replacement* cost of productive capacity used;
- (2) The current costs of inventory sold; and
- (3) A ‘capital charge’ on net assets employed.”

—*Air-Conditioning and Plumbing-Products Manufacturing Executive*

“Operating income includes net revenue less operating expenses, excluding amortization of intangible assets.”

—*Television and Radio Broadcasting Network Executive*

“Net operating income [includes] profits before nondepartmental expense (i.e., interest income and expenses, corporate executive expense, gain or loss on sale of properties, etc.) and taxes on income.”

—*Printing and Publishing Company Executive*

“Operating profit [is determined] before other income, interest charges and taxes.”

—*Electrical Manufacturing Company Executive*

Another variation of net income is *profit contribution*. At a pharmaceutical and consumer-products firm this is defined as “operating income less financial expenses (e.g., bank charges and interest) and exchange gains or losses (resulting from both transactions and translations) plus an assessment approximately equal to the company’s percentage of cost of debt (before taxes) which is applied to the monthly receivable and inventory balances.”

Rate-of-Return Indicators

Rate-of-return indicators also come in many forms. Rate of return on assets (or assets employed or managed) is widely used. And, as with several of the other popular indicators, companies have developed variations from the simple ratio of income to assets. (See Appendix I, Table 2.) The relative popularity of the rate of return on assets measurement in assessing divisional performance is probably due in part to the fact that management accountants have somewhat less difficulty in assigning assets fairly and accurately to divisions than they do in allocating certain liabilities. This makes return on assets a more acceptable indicator to division managers also.

The surveyed companies display quite a bit of individuality in how they define return on assets. Here are three formulas:

“Return on assets employed [is] net income plus interest expense (net of tax) divided by average of total assets less current liabilities.”

—*Diversified Manufacturing Company Executive*

"Operating return on assets employed [is] defined as operating earnings divided by working capital plus net property, plant and equipment."

—*Forest and Speciality Products
Manufacturer Executive*

$$\text{Return on net assets} = \frac{\text{Operating Income}}{\text{Total assets - (Accounts Payable + Accruals)}}$$

—*Hotel and Restaurant Chain Executive*

Rate of return on capital (or capital employed) also is popular with the surveyed companies. Capital, when used in connection with a business unit, usually refers to the sum of whatever debt can be identified with the unit plus its net worth. Computational approaches include these:

"Return on average capital employed is defined as after-tax divisional profit contribution divided by average capital employed."

—*Pharmaceutical and Consumer Products
Company Executive*

"Return on invested capital, before and after tax, is profit on invested capital (before long-term financing costs) divided by average invested capital."

—*Consumer Food Products Company Executive*

"Return on capital employed [is] operating income divided by the average of interest-bearing debt, other long-term liabilities, and equity."

—*Diversified Retailing and Manufacturing Firm
Executive*

One company (in the chemicals and consumer-services sectors) distinguishes in its return on capital computations between subsidiaries that are wholly-owned and those in which there are minority interests. As its chief financial officer explains:

"Return on total capital employed [by wholly-owned subsidiaries is] defined as net income (100 percent ownership basis) plus the after-tax cost of interest, divided by total capital employed. Total capital employed is the sum of net fixed assets, net working capital, other assets/liabilities-net, short and long-term debt including FAS # 13 leases, and goodwill.

"Return on company capital employed [is] defined as net income (company's share) plus the after-tax cost of interest on company guaranteed debt divided by company capital employed. Company capital employed equals total capital employed less non-company guaranteed debt less minority interest in net worth."

Rate of return on equity can be a troublesome statistic for management accountants to deal with. When a business unit is organized as a separate corporate entity or a subsidiary, there is no difficulty because the subsidiary has its own balance sheet and its shareholders' equity is readily apparent. However, when the unit is simply a division of a parent company, it is often difficult to allocate corporate assets and liabilities with fairness and accuracy so that a credible "equity" amount can be identified. Consequently, although return on equity is a basic financial analysis tool for measuring corporate performance,

many managements feel more comfortable with other rate-of-return computations when assessing divisional performance.

Asset and Liability Management Indicators

The effectiveness with which division executives manage the assets and liabilities entrusted to them is a matter of keen interest to corporate management. In many companies, inventories and receivables are the most important assets under the control of divisional management. Such indicators as turnover (that is, the number of times the average investment in inventories is "sold" in each accounting period) and days' (or weeks' or months') sales invested in such assets provide readings on how divisional management is performing this responsibility. Changes in these measurements from one reporting period to another are of particular interest. Turnover is also an important statistic for measuring efficiency in other areas of asset and liability management. Companies use this indicator in assessing working-capital management, asset management in general, and capital management in general.

Corporate management is also concerned within how well divisions manage productive facilities. In many companies, however, the authority of division managers to commit and spend money for such facilities is limited.⁴ One of the pitfalls of measuring the efficiency of divisions' use of production facilities is that it may encourage business-unit management to retain older, lower-cost equipment rather than invest in newer, more costly, but also more efficient facilities. The experience and judgment of corporate executives are needed in such situations to interpret what the divisions' performance indicators really reveal.

Other Indicators

The survey respondents' use of less common financial indicators, including cash flow, revenues, cost and expense control, and coverages is presented in Appendix I, Tables 4-7. Any of these measures can be of overriding importance in certain circumstances—for instance, if cash flow is spotty or inadequate.

"Most Important" Measures

The respondents were asked which indicator they rated *most* important, useful and reliable. But clearly there is no such magic measurement, for there were over twice as many "most important" votes (208) as there were respondents (85). One company listed 10 indicators in answer to the question. Practically no company finds it feasible to rely on a single measure of performance.

But while few companies single out one indicator, the votes overwhelmingly favor rate-of-return and income indicators:

⁴ This is a subject that has received close attention in previous Conference Board publications. See, for example, Patrick J. Davey, *Managing Capital Investments*. New York: The Conference Board, Inc., Research Bulletin No. 165, 1984.

<i>Class of Indicators</i>	<i>Number of Mentions as "Most Important"</i>
Rate of return	72
Income	60
Cash flow	28
Asset and liability management	21
Volume of business	18
Other	9
Total	208

If "most important" votes are arrayed by specific measurements within these broad classes of indicators, the most popular are:

<i>Specific Indicator</i>	<i>Number of Mentions</i>
Income (absolute dollars)	27
Income from operations	21
Cash flow	21
Rate of return on assets	19
Rate of return on investment	15
Rate of return on equity	15
Rate of return on capital	14

Here are some representative comments about preferred indicators:

- The chief financial executive of a building-products manufacturer names "operating profit, net cash flow, return on investment and working investment turnover." And he adds, "These measurement criteria reflect operating performance over both the short and long term, as well as the effectiveness of resource and asset utilization."

- The vice president for financial planning of an energy company bases his selections partly on the effects that certain indicators have on the investment community's perceptions of the company:

"Operating income measures the unit's contribution to the net income stream reported to the financial community. The operating return on investment ratio relates such income to the reported balance sheet values. Thus, these two measures tell us how the financial community perceives the business."

But management considerations are important, too.

"On the other hand, cash income, by eliminating the effects of relatively arbitrary accounting matters (e.g., depreciation policy and deferred tax accruals), reflects the unit's contribution to the company's free cash flow. This amount is then related to the gross investment, which eliminates the accounting effects."

- The chief financial officer of a transportation products and services company emphasizes the importance of choosing the right kinds of financial indicators for the particular business unit being evaluated. He states:

"Return on performance assets is particularly useful for our manufacturing businesses, which are in predominantly mature industries. We use average performing assets to approximate closely the corporation's investment in that business. "We believe shareholders evaluate the corporation's performance to a large extent by its return on stockholders' equity.

Return on performing assets is a reliable measurement of the business unit's efficient use of its assets and is consistent with our return on equity measurement.

"Return on sales and sales growth are better suited to evaluating service industries, particularly if the service is in a rapidly expanding phase. Service industries are normally not as capital intensive as manufacturing, and their investment is usually insensitive to large changes in volume. Less attention is given to how quickly assets are turned and focused on the return-on-sales measurement. Sales-growth measurements are useful in determining market-share achievement."

Pros and Cons of Selected Indicators

One reason for using a number of indicators is that the various types of measurements tend to emphasize certain phases of business-unit performance at the expense of other important considerations. For example, income indicators can give a lot of information on how the "bottom line" is derived, but they give no indication of how well the unit manages the assets or capital entrusted to it. Rate-of-return measurements are needed to evaluate that.

Some companies are now attempting to measure how each business unit contributes to overall shareholder wealth. Rate-of-return indicators do not serve this purpose because they relate current income to various historical costs, or book value, on the balance sheet. An electrical equipment manufacturer has developed a sophisticated mathematical model that estimates the current market value of each division; the sum of these amounts for all divisions equals the total market value of the corporation.

Rate-of-Return Indicators

Rate-of-return indicators, in general, help to identify business-unit strengths and weaknesses that affect overall company performance; measure the ability to produce above-average earnings; and have more significance over the longer term than income measures.

Return on assets closely approximates an investor's return on equity, while at the same time removing both the leverage element that is inherent in the return-on-equity measurement and the difficulty of calculating a credible equity amount for an unincorporated business.

Return on investment (ROI) is a widely-understood statistic and the data to compute it are readily available.

Return on equity (ROE) is also easy to understand. It relates most closely to a company's externally reported performance, to its standing with investors, and to the corporate goal of maximizing shareholder wealth. ROE reflects long-term performance with the least distortion; facilitates comparisons of business units with stand-alone competitors; and is useful in gauging profitability for capital-asset decisions.

Return on capital is useful in making comparisons among business units within the company as well as with peer firms outside of the company, regardless of the units' size, labor or capital intensiveness; it is fair because divisions are not respon-

sible for the corporate financial structure, only for the capital entrusted to them.

But rate-of-return calculations also come in for criticism because:

- They tend to be distorted because the investment, capital employed, assets, or equity bases to which income is related are governed by historical costs that often have little or no relationship to current values. (This criticism, of course, applies just as well to the corporation as a whole.)
- They tend to be distorted by accounting allocations and estimates and by the inventory transfer-pricing practices on which division financial statements are based.
- They are not very meaningful when applied to units whose businesses are not capital intensive.
- It is often difficult to determine standards by which rates of return in individual divisions can be evaluated.
- Equity is difficult to allocate fairly to unincorporated divisions and is often meaningless in the case of small subsidiary corporations.
- Internal rate-of-return, which is a commonly-used tool in capital investment decision-making, is difficult to use on a company-wide basis.
- For some rate-of-return indicators, such as operating return on assets, it may be difficult or impossible to obtain comparative data for competition.
- In return-on-asset computations, the calculated asset base may not include all of the assets actually used by an individual division. For example, divisions may use corporate facilities and services for which they are not charged.

Income Measurements

Income measurements get the greatest share of attention both internally and externally because of their pertinence to overall corporate profits; are the easiest numbers to calculate and track at lower levels of the organization; reflect management's response to its environment in the short-term; and relate directly to management's goals of increasing growth and profitability, thereby enhancing shareholders' wealth.

Income from operations (compared with net income) more clearly reflects the performance of a business unit in those areas for which unit management is responsible.

Operating income before taxes excludes the effects of extraneous items like extraordinary write-offs or gains and losses on the sale of assets.

Earnings per share not only calls attention to the goal of maximizing shareholders' wealth, but is also commonly reported by rating agencies.

Growth rates of earnings indicate the momentum of a business unit and may also suggest how long present trends might continue.

But income-driven measurements are subject to criticism because they often lack comparability across business-unit lines, especially if units are engaged in drastically different lines of business. Such measurements may not reflect the different risks to which diversified business units are exposed. (This shortcoming is also attributed to earnings per share measurements.)

Net income is subject to distortion by non-operating revenues and expenses, by income-tax allocations, and sometimes by allocations of corporate charges.

The modified measurements of income—income before interest charges and/or income taxes, income from operations—that some companies employ to correct the distortions just mentioned have drawbacks of their own. They may not relate to the investment required in particular lines of business; do not take the cost of capital into consideration; and tend to promote short-term thinking.

Other Indicators

Other financial indicators also have their advantages and disadvantages:

Cash-flow measurements, as noted, are especially significant for companies whose flows are not up-to-snuff. Beyond that, cash flow is favored as an all-encompassing measurement of business performance that also focuses attention on balance-sheet management.

On the other hand, cash-flow measurements lack predictive value and can be distorted by allocations, estimates, and transfer pricing practices. In the early stages of a line of business, cash flows tend to be erratic and often are negative.

Days' sales in accounts receivable not only show how well the company's credit and collection function is performing, but can also give an indication of customer satisfaction. But these figures can be misleading. In a firm that does considerable government contracting, this statistic is affected by percentage-of-completion accounting and by progress payments.

Inventory-management measurements reveal efficiency in manufacturing and provide warnings when the investment in inventories begins to become excessive. Inventory turnover rates are, of course, inapplicable for some companies (such as utilities); for others they can be distorted by unusual events like the sales-incentive programs automobile manufacturers periodically sponsor.

Volume of sales or revenues relates directly to growth and profitability; it also provides the most direct measurement of deliveries to customers.

The growth rate is regarded by some executives as the best long-term measurement of business health.

New orders help to monitor a company's market share. One executive believes that other financial measurements may show improvement automatically if the company's market share is growing.

On the other hand, revenue may not be closely correlated with net income or cash flow.

Return on sales finds favor because declines in this measure may be a warning of reductions in operating profits; it relates closely to long-term goals of growth and profitability. In evaluating service businesses, it is especially useful because the assets in such businesses are usually comparatively small.

Assets employed, asset turnover, and investment in current assets may indicate an excess investment in various types of assets.

Current Techniques: A Comparison with Earlier Conference Board Research

In 1984, The Conference Board published "Measuring Business Performance" (Research Bulletin 153), which reported the results of a survey on the use of corporate performance indicators, based primarily on responses from chief executive officers of *Fortune* 1000 industrial companies. Participants were asked to rank the relative importance of the various corporate performance measurements used in decision-making.

Comparison of the two studies illustrates the different approaches to managing business units as compared with managing overall corporate entities. For example, income from operations is very important in evaluating a division but receives no mention at all in assessing the company as a whole. In contrast, debt management receives scant attention at the divisional level, but a great deal at the corporate level.

The results of the earlier ranking appear in the right-hand column of the following tabulation. The left-hand column summarizes the responses of the present survey participants to the question of which business-unit performance indicators are most important.

Discounted cash flow and *internal rate of return* measurements reveal the results of past investment decisions.

Debt ratio is significant because of its effects on debt ratings and financing costs.

Same Measurements for All Units?

Most executives responding report that the same financial measurements are used for all business units in their companies. When different measurements are applied to different units, it is because of dissimilarities in the business in which the units engage or the environments in which they function. Some examples:

- A company in the aerospace industry emphasizes return on investment for its commercial enterprises and return on assets managed for government contracts.
- A food-products company focuses on rate of return measurements for its domestic business, but uses net earnings for its international ones because of their different financial structures and tax rates.
- Two companies in the telecommunications field have both regulated and unregulated subsidiaries. The regulated ones are evaluated according to their return on the rate base, while the more usual rate of return computations are made for unregulated businesses.
- A company with both manufacturing and retail operations evaluates manufacturing divisions according to operating income and return on capital; for its retail operations, the combination is inventory turnover and return on capital.
- The small size of some of their subsidiaries causes two firms to avoid using return on equity as an indicator, because at the outset such companies are provided with only nominal

	Number of Times Mentioned as Most Important	
	Business-Unit (85 respondents)	Corporate (101 respondents)
<i>Rate of return indicators</i>		
On assets	19	10
On investment (unspecified)	15	4
On equity	15	46
On capital	14	42
On sales	9	38
Internal rate of return	-	1
Sub total	72	141
<i>Income indicators</i>		
Income (absolute \$)	27	44
Income from operations (absolute \$)	21	-
Contribution to corporate results	6	-
Earnings per share (EPS)	3	29
Growth rates of income	3	3
Sub total	60	76
Cash flow	28	2
<i>Asset and liability management indicators</i>		
Inventory management (e.g., turnover rate)	6	6
Days' sales in receivables	4	3
Current ratio	-	5
Assets employed	4	-
Asset turnover rate	4	1
Debt ratios (e.g., debt to equity)	1	26
Other	2	-
Sub total	21	41
<i>Volume of business indicators</i>		
Revenue volume	8	1
Revenue growth rate	6	2
New orders	2	-
International orders	1	-
Market-share growth rate	1	-
Sub total	18	3
Break-even point	-	12
Cost of capital	-	7
Other (mentioned only once or twice each)	9	12
Total mentions	208	294

amounts of equity capital. Return on equity is applied to the more substantial subsidiaries, however.

Some companies cannot or do not apply established business indicators to new or "start-up" units. One of the basic difficulties, of course, is the lack of historical data for comparisons. One firm stresses comparisons with *projected* net income and *projected* revenue growth.

Indicators Used for Incentive Compensation Programs

The survey also asked which financial performance indicators were used in the administration of incentive compen-

sation programs for business-unit managers. Nine of the responding executives either have no incentive compensation program or do not use any specific business-unit performance measurements for this purpose. The remaining 76, however, employ anywhere from one to ten different indicators in their incentive compensation evaluations. Some of these firms, of course, operate more than one incentive compensation program.

Again, despite the variety in specific measures (or combination of measures) used, the vast majority of indicators for business-unit compensation fall into two broad classifications:

- *Income* indicators (mentioned 74 times);
- *Rate-of-return* measurements (mentioned 55 times).

Less frequently mentioned are:

<i>Class of Measurement</i>	<i>Number of Times Mentioned</i>
Volume-of-business indicators	15
Cash-flow measurements	11
Asset-management indicators	11
Cost- and expense-control indicators	9
Others	9

Nonfinancial Measurements

All but nine of the companies represented in the survey also employ nonfinancial measurements in their appraisals of business-unit performance. In all, 78 different measurements were identified. These indicators, along with the frequency with which they were mentioned, are listed in Tables 1-4, which classify the measurements according to their orientation—marketing, production, human resources and others. The companies tend to use anywhere from one to eight different indicators. The five most popular are:

- Market share (mentioned 45 times);
- Quality and reliability of products and services (mentioned 30 times);
- Manufacturing productivity (mentioned 26 times);
- Introduction of new products or services (mentioned 17 times);
- Sales-volume growth (mentioned 12 times).

Usefulness

The 76 respondents who employ nonfinancial measurements compare them with financial indicators this way:

More useful than financial	9
Less useful than financial	17
About equally useful	28
Not sure—no response	22
	76

The tables (in Appendix II) show the specific measurements included in each of these categories.

Some companies that do not employ these financial performance indicators look to external conditions as the basis for granting incentive awards. The chief financial officer of a television and radio broadcasting network, for example, describes his company's approach this way:

"Incentive compensation awards are not specifically tied to any financial measurement. Short-term incentive compensation is in the form of annual cash bonuses, which are determined based on current-year results compared with original budgets, with substantial consideration given to the actual operating conditions of the marketplace for that year, together with the improvement (or deterioration) in the strength of the operating unit's franchise during that year. Long-term incentive awards are also granted on the same criteria, with greater consideration given to potential future performance and retention of key employees. Such long-term incentive awards are based partly upon the performance of the company's common stock during the life of the award, which of course reflects the collective performance of all the operating units."

Some of the minority who consider them more useful point out that the nonfinancial indicators measure underlying forces that ultimately affect financial performance. Says the chief financial officer of a chemical manufacturing company:

"For specific situations, these measures provide more immediate monitoring and control of the important characteristics of a unit at a particular point in time, from which success in the financial measures will follow."

Other executives assert that nonfinancial indicators also have more long-term significance than most financial indicators. As one executive observes: "Market share is the best long-term indicator of the health of a business."

Survey participants who consider nonfinancial indicators less useful argue that many nonfinancial measurements are somewhat fuzzy and lacking in objectivity; they are therefore less reliable. Others believe that enhancement of shareholder wealth is management's principal duty and that financial indicators are consequently of much more significance. An executive of an international petroleum company adds this thought:

"Although nonfinancial measures are used in the analysis of changes in income levels, income remains the primary measure. Higher sales volumes by themselves do not necessarily translate into higher income if the mix of product sold has shifted to lower margin items."

Table 1: Marketing-Oriented Indicators

	<i>Number of Times Mentioned</i>
Market share	45
New products or services introduced	17
Sales volume growth	12
Sales volume	8
Expansion into new markets	5
Customer satisfaction	5
Number of new customers	4

The following measurements were each mentioned one to three times: market penetration; customer service; sales-force performance (calls); product mix; delivery performance; order backlogs; competitive position; age of products; proprietary position; innovation; price measurements; discounts compared with competition; equivalent marketing units per salesperson.

The following specialized industry measurements were mentioned once each: unit volume-conversion minutes (telephone company); KWH sales (electrical utility); occupancy rate (hotel chain); network grade of service (telecommunications); access minutes of use (telephone company); transactions (rental and leasing company); fleet size (rental and leasing company); carloadings (railroad).

The participants who consider both types of indicators about equally useful point out that these measurements complement one another and are both important to gain the total picture of a company.

Respondents who did not state a firm opinion on the relative usefulness of financial and nonfinancial indicators nevertheless make considerable use of both. Perhaps their uncertainty is rooted in the difficulty of achieving precise measurements of many nonfinancial indicators. An executive of a telecommunications company cautions:

"It is very important that these nonfinancial items be defined not as general statements but as specific action items with specific milestone dates; otherwise they are very ineffective."

Incentive Compensation

Forty-three survey participants use nonfinancial measurements in their incentive compensation programs. And, in most cases, the nonfinancial indicators that they regularly include to appraise business-unit performance are the same ones that they use for incentive compensation purposes. A number of the others report that their incentive compensation programs

Table 2: Production-Oriented Indicators

	<i>Number of Times Mentioned</i>
Quality and reliability of products and services	30
Manufacturing productivity	26
Production levels	4
Capacity utilization	3

The following measurements were each mentioned one to three times: additions to reserves (oil and gas companies); refinery throughput (petroleum); production rates; costs of quality-improvement programs; economies of scale; technology development; inventory control; drilling success (petroleum); pipeline throughput (gas); product yield (agricultural producer); condition of facilities (hotel chain); track, crossties and ballast laid (railroad); equipment in storage (railroad); equipment repaired (railroad).

Table 3: Human Resources-Oriented Indicators

	<i>Number of Times Mentioned</i>
Employee headcounts	8
Attainment of affirmative action goals	6
Employee development	5
Management development	5
Safety	4

The following measurements were each mentioned one to three times: organization development; employee satisfaction; employee motivation (morale); employee turnover; employee productivity; human-resources enrichment; standard labor hours (hotel chain).

Table 4: Other Nonfinancial Indicators

Business Ethics:

Integrity of management
Adherence to corporate code
Community service
Social responsibility
Attainment of strategic goals
Cooperation with other divisions
Enhancement of MIS system
Successful capital projects
Acquisitions completed
Environmental factors

include goals—frequently nonfinancial—that individual business-unit managers are expected to reach for their units: affirmative action or improved product quality, for example.

Standards of Comparison

Standards of comparison for business financial performance are commonly developed in the planning and budgeting process, especially revenue and profit targets that reflect recent performance as well as expectations.

The real question, however, is how these criteria are derived. Among the firms surveyed, the performance of other companies, especially competitors or peers, and the averages for industry groups are the principal considerations in setting standards for divisional financial performance. For example, an executive of a business equipment manufacturing company says:

"Our business units each set benchmarks for themselves against their best competitors, the leaders in the industry or function. Year-over-year improvements are expected, with the goal of being the industry leader, and keeping all long- and short-term objectives in perspective."

Ten companies have set specific rate-of-return targets. One such company, for example, looks for a rate of return on capital exceeding that of companies in the Standard & Poor's 500 stock index. A public utility company seeks a rate of return equal to that allowed by its state public utility commission.

Other financial benchmarks cited by the respondents are:

- Investors' expectations
- Rates of return offered by alternative investments
- Cost of capital

Changes in Standards

Most of the surveyed companies have made few or no changes during the last few years in the goals and standards they use for measuring business unit financial performance. However, some executives point out that while the standards may not change, the quantities attached to them change frequently in response to developments in economic and business conditions for the company as a whole or for individual divisions. Changing conditions also lead to shifts in emphasis on certain indicators.

Some respondents also state that increased competitiveness in their lines of business, both domestically and internationally, has caused them to "develop a sharper pencil" in evaluating business-unit performance. Not only has this led to more financial indicators in their internal reporting systems, but reporting and reviewing of indicators have become more formal processes in recent years.

Who Establishes Standards

Senior corporate management is ultimately responsible for establishing criteria for evaluating divisional financial performance. In some companies the chief executive officer, alone,

does this. Much more often, however, it is a team effort with the chief financial executive playing an important role. Because of the sophisticated planning and financial control systems in many corporate headquarters, it is common for many specialists to get involved in the standard-setting process. The controller (and staff), the budget staff, the planning staff, the acquisitions group, the human-resources staff and corporate economists are all mentioned by various survey cooperators as participants.

Typical of this "top-down" approach to standard setting is the following statement by an executive of a diversified agricultural products company:

"Return-on-assets guidelines are imposed by the president after being developed in conjunction with the corporate budget function. Competitor financial information is monitored by the corporate economics function."

But not all companies derive their divisional financial performance criteria exclusively from corporate headquarters. Thirty-seven of the survey respondents state that their business-unit managements participate in establishing negotiated standards for assessing performance. The chief financial officer of a pharmaceutical and consumer products company describes his firm's approach:

"Standard setting, i.e., the plan, is a bottom-up development process based on strategic direction established by corporate management. Throughout the planning process, there is considerable bottom-up/top-down dialogue before the plan is approved."

Because of the importance of financial performance criteria, many of the survey participants also request approval or ratification from their boards of directors of the standards developed by management.

How Results Are Monitored

The firm's internal financial reporting system is the instrument that is almost invariably used to monitor actual results in comparison with established criteria. The large, complex companies that participated in this study usually prepare monthly managerial accounting reports as a matter of routine; financial indicators are typically included. In some firms, however, certain comparisons and analyses are done only on a quarterly or annual basis because some indicators (for example, rates of return) are not considered meaningful for short periods of time.

Monitoring business performance is also accomplished through periodic reviews. The executive vice president of a pharmaceutical products company, for example, describes his firm's practice:

"Regular performance reviews are conducted at all operating levels, from subsidiary to the corporate function, and the results of such reviews are channeled to the Corporate Operating Committee at regularly scheduled meetings. These mechanisms are likewise supported by a formal semiannual written report of the progress against approved goals."

An international chemicals, natural-resources and consumer services company schedules two types of review meetings. Its chief financial officer states:

"Actual performance is closely monitored by all levels of management in the form of:

- (i) Monthly operating reports.
- (ii) Bimonthly operating review meetings attended by groups and corporate management to discuss current issues facing the businesses and to review year-to-date results.
- (iii) Annual business plan review meetings to discuss and review the past year's performance, the next year's budget, and the five-year forecast."

Influence of Performance Measurements

Do performance measurements have any significant effects on the real success or failure of the entities that are measured? Perhaps even more important, do they encourage too much focus on the short term because of the perceived importance of maximizing the current period's earnings?

Real Effects on Performance

The survey participants overwhelmingly agree that performance measures have significant effects on divisional results. Seventy-four executives hold this view; only two dispute it; and two are not sure. These last two base their views on the relative newness of their firms' performance-measurement systems and thus the lack of conclusive experience.

Executives cite these reasons in supporting the importance of divisional performance measures.

- Division managers' compensation is directly linked to the results shown by performance measurements;
- Overall corporate results, and improvements therein, show the effects of stressing certain performance indicators;
- Performance indicators enable business-unit managers to know what is expected of them and to act in accordance with the priorities established by top management;
- Careful monitoring of performance has led to corporate decisions to divest certain divisions or subsidiaries and to restructuring and redirection.

The chief financial executive of a building products manufacturing company believes strongly in the motivational effects of performance measurements. He concludes:

External Sources of Comparative Information

Information about the financial performance of competitors, peer companies, and industry groups is readily available. Much of it consists of published data that are either free or low-cost. A great deal of it, of course, must be analyzed and modified to put it on a basis that is comparable with a firm's data. Some widely-used sources are:

- Trade association and industry statistics
- Annual and quarterly shareholders' reports and 10-Ks
- Dun & Bradstreet, Inc. Key Business Ratios
- Standard & Poors Compustat Services, Inc.
- Fortune "500" and "1,000" statistics
- Forbes statistics
- Business Week statistics
- Robert Morris Associates Annual Statement Studies
- Security analysts' reports and reviews
- Newspaper and magazine articles about other companies.

"Because of the approach used in developing these performance measurements and their integration into the compensation, incentives and performance/promotional systems, they will focus divisional actions, plans and strategies on those factors which lead to attainment of these performance objectives. Division management time and effort is therefore not spent on extraneous issues."

A Negative Consequence: Short-Term Perspective

Yet, sixty-five survey respondents also believe that the short-term, historical emphasis of most financial measurements may encourage short-term thinking on the part of unit managers. Two executives disagree with this view.

The vice president and controller of a consumer electronics manufacturing company endorses strong action by top management to overcome the divisional tendency to emphasize short-term results:

"We recognize that division managers are influenced by selection of performance measurements. One of the challenges of senior corporate officers is to select correct performance measurements, and in this regard we identify longer-term performance elements that are included in the measurements system. For example, as part of the fixed-cost reporting routine we segregate those resources devoted to new product development and product improvement versus standby or readiness-to-serve costs. Management understands that failure to complete programs to improve current operating results is not generally acceptable performance. Similarly, failure to maintain adequate levels of investment in employee training and advertising programs to achieve short-term operating results is discouraged and in some cases not permitted."

An executive of an agricultural products firm adds that top management pressure is augmented in his company by other measures. He states:

"There can be a tendency to overemphasize the short-term at the expense of the long-term. This company combats such a tendency by presidential 'jaw-boning,' by looking at measures on a cumulative basis, by preparing the business plan for five years in the future, while reporting three years in the past, and by the use of 'action plans' to ensure that certain steps will take place regardless of financial results. The first year of the plan is looked upon as the first step toward achieving a five-year goal."

But by far the most frequently-mentioned means of counteracting the tendency toward short-term thinking is the

adroit design of business unit executives' incentive compensation plans. Tying incentives to attainment of long-term and nonfinancial goals in addition to the usual period profit targets is a widely-used strategy among the survey cooperators. One company, a consumer products firm, has an interesting twist to this approach. The vice president and controller concludes:

"There is the danger managers will go overboard to generate a large bonus one year and to worry about next year when it gets here. We try to combat that by not awarding all the funds generated by the formula and by encouraging steady growth rather than peaks and valleys. We carry over unallocated funds to the next year so employees can be compensated for a job well done when economic conditions may prevent a normal result from occurring."

Appendix I

Table 1: Income Indicators

	<u>Number of Times Mentioned</u>	
<i>Income (absolute \$):</i>		
Otherwise unspecified	29	
Before income taxes	12	
Before interest and taxes	1	
Before interest, taxes, and translation gains (losses)	1	
Before finance charges	1	
Before and after corporate overhead and interest	1	45
<i>Income from operations (absolute \$):</i>		
Otherwise unspecified	17	
Before income taxes	3	
Before interest and taxes	1	
After taxes	3	24
<i>Profit margin indicators:</i>		
Income as a % of sales	10	
Income from operations as a % of sales	4	
Income before taxes as a % of sales	1	
Profit before claims, investment income and overhead as a % of premiums (insurance subsidiary)	1	16
Contribution to corporate results (net income, EPS)	8	
Earnings per share (of subsidiary companies)	4	
Controllable profits	1	
Profit per unit of product sold before overhead	1	
Selling profit	1	
<i>Growth rates of:</i>		
Net income, profit, or earnings	5	
Earnings per share and dividends (of subsidiaries)	2	7
Total mentions		<u>107</u>

Table 2: Rate of Return Indicators

	<u>Number of Times Mentioned</u>	
<i>Rate of return on assets:</i>		
Otherwise unspecified	15	
On net assets	7	
On average net assets employed	1	
On total operating assets	2	
On performing assets	1	
On controllable assets	1	
On assets, before taxes	1	
On rate base (utility company)	1	29
<i>Rate of return on capital:</i>		
Otherwise unspecified	16	
On invested capital	5	
On invested capital, before taxes	1	22
<i>Rate of return on investment:</i>		
Otherwise unspecified	18	
Operating return on investment	1	
Cash return on investment	1	
Base return on investment	1	21
Rate of return on equity		18
Rate of return earned in comparison with rate allowed by regulatory authority (utility company)		1
Total mentions		<u>91</u>

Table 3: Asset and Liability Management Indicators

	<u>Number of Times Mentioned</u>	
<i>Inventory management indicators:</i>		
Turnover	13	
Days, weeks, or months sales in inventories	9	
Inventory level	1	
Average inventory as a % of sales	1	
Gross profit return on inventory	1	25
<i>Accounts receivable management:</i>		
Days sales outstanding	17	
Turnover	2	19
<i>Facilities management:</i>		
Capital commitments and actual expenditures for facilities	5	
Average investment	2	
Discounted cash flow and internal rate of return evaluation	2	
Percent of construction internally financed	1	
Construction work in process as a percent of plant (utility company)	1	
Ratio of change in gross fixed assets to change in sales	1	
Gross profit per square foot of selling space	1	13
<i>Asset management, in general:</i>		
Asset turnover	9	
Average assets or assets employed	2	
Ratio of sales to assets	1	12
<i>Working capital management:</i>		
Turnover	2	
Current ratio	2	
Working capital (absolute \$)	1	
Ratio of change in working capital to change in sales	1	
Current asset investment needed to support volume of business	1	
Average working capital as a percent of sales	1	8
Debt to equity ratio		4
<i>Accounts payable management</i>		
Accounts payable days outstanding or days cost of goods sold in accounts payable	3	
Accounts payable as a % of inventory	1	4
<i>Capital management, in general:</i>		
Net asset base	1	
Average capital employed	1	
Capital turnover	1	3
Total mentions		<u>88</u>

Table 4: Cash Flow Indicators

	<u>Number of Times Mentioned</u>
Cash flow (not otherwise described)	29
Cash flow from operations	9
Internal funds generation	4
Net cash flow	2
Operational cash flow, before financing	2
Cash performance	2
Cash flow before and after corporate overhead and interest	1
Net cash flow as a percent of capital	1
Cash excess or deficit	1
Cash use vs. budget	1
Investment center cash flow	1
Total mentions	<u>53</u>

Table 5: Volume of Business Indicators

	<u>Number of Times Mentioned</u>
Sales or revenue volume	15
Gross margin on sales	12
Growth of current revenue or sales volume	8
Customer orders	3
Backlog of orders	3
Growth of customer sales base	1
International orders	1
Marketing channel contributions	1
Noninterest income (bank holding company)	1
Specific industry revenue indicators (e.g., hotel occupancy rates, and gambling casino revenue rates)	1
Total mentions	<u>46</u>

Table 6: Cost and Expense Control Indicators

	<i>Number of Times Mentioned</i>
Ratio of costs and expenses to revenues	5
Level of plant, production and operating expense	2
Level of selling and G&A expenses	2
Operating and maintenance expenditures in comparison with budgets	1
Cost improvements accomplished	1
Ratio of expenses to gross margin	1
Prime cost coverage	1
Total mentions	<u>13</u>

Table 7: Other Indicators

	<i>Number of Times Mentioned</i>
<i>Coverage indicators:</i>	
Interest coverage, or pretax interest coverage	5
Debt coverage	1
Dividend coverage	1
	7
<i>The following indicators were mentioned once each:</i>	
Book value per share	
Ratio of market value to book value	
Bond rating	
Allowance for funds used during construction as a percentage of income to common shareholders (utility company)	
Comparative balance sheets	
Effective tax rates	
R&D expenditures	
Employees, rates paid	
Employee compensation as a percent of sales	

Appendix II

Table 1: Income Indicators Used in Incentive Compensation Programs

	<i>Number of Times Mentioned</i>
Net income	16
Net income as a % of sales	1
Net income before taxes	6
Net income before interest and taxes	1
Net income before finance charges	1
Net income before taxes—margin %	1
Net income growth	7
Attainment of net income objectives	1
Net income from operations	15
Net income from operations before taxes	4
Net income from operations after taxes	3
Net income from operations as a % of sales	1
Contribution to corporate results (Earnings, EPS, Operating Profits)	9
Overall company results	3
Operating cash income	1
Profit on sales	1
Gross margin %	2
Margin improvements	1
Total mentions	<u>74</u>

Table 2: Rate of Return Indicators Used in Incentive Compensation Programs

	<i>Number of Times Mentioned</i>
Return on investment	12
Return on capital	10
Return on equity (of subsidiary corporations)	9
Return on assets (or assets employed)	8
Return on net assets	4
Return on sales	3
Return on invested capital	2
Return on investment—operating	1
Return on investment—cash	1
Return on invested capital before taxes	1
Return on performing assets	1
Return on controllable assets	1
Long term return on capital	1
Three year average return on net operating assets	1
Total mentions	<u>55</u>

Table 3: Volume of Business Indicators Used in Incentive Compensation Programs

	<i>Number of Times Mentioned</i>
Sales or revenue volume (in dollars)	5
Growth of current revenue or sales volume	4
New customer accounts	1
Growth of customer sales base	1
Growth of market share	1
Growth of deposits and loans (bank holding co.)	1
Load factor improvements (public utility)	1
Marketing channel contribution	1
Number of times mentioned	<u>15</u>

Table 4: Cash Flow Indicators Used in Incentive Compensation Programs

	<i>Number of Times Mentioned</i>
Cash flow	6
Internal funds generation	2
Net cash flow	1
Net cash flow from operations	1
Operational cash flow	1
Number of times mentioned	<u>11</u>

Table 5: Asset Management Indicators used in Incentive Compensation Programs

	<i>Number of Times Mentioned</i>
Days' sales outstanding in receivables	3
Inventory turnover	2
Days' sales in inventories	1
Working capital turnover	1
Average investment	1
Capital commitments/expenditures	1
Ratio of sales to assets	1
Average assets	1
Number of times mentioned	<u>11</u>

Table 6: Cost and Expense Control Indicators Used in Incentive Compensation Programs

	<i>Number of Times Mentioned</i>
Ratio of operating expenses to revenues	3
Cost improvements accomplished	2
Operating and maintenance expenses in comparison with budgets (utility co.)	1
Plant expenses	1
Expense control (unspecified)	1
Number of times mentioned	<u>8</u>

Table 7: Other Indicators Used in Incentive Compensation Programs

	<i>Number of Times Mentioned</i>
Attainment of individual objectives	5
Nonfinancial considerations	1
Comparisons with other companies	1
Value creation (as measured by the ratio of market value to book value)	1
Other (not specified)	1
Number of times mentioned	<u>9</u>

Appendix III

Additional Readings

Financial ratios and other performance indicators usually receive extensive coverage in the textbooks on finance, investment analysis, and accounting. A few examples are:

James C. Van Horne, *Fundamentals of Financial Management*. Englewood Cliffs, N. J.: Prentice-Hall, Inc., 4th Edition, 1980, Chapter 6, "Financial Analysis."

Glenn A. Welsch, Charles J. Zlatkovich, and Walter J. Harrison, Jr., *Intermediate Accounting*. Homewood, Illinois: Richard D. Irwin, Inc., 6th Edition, 1982, Chapter 21, Part A.

In addition, there are studies of company practices and experiences with financial indicators. Some examples are:

David Solomons, *Divisional Performance: Measurement and Control*. New York: Markus Wiener Publishing, Inc., 2nd Edition, 1985. (Originally published in 1965 by Financial Executives Research Foundation.)

James B. Edwards, *The Use of Performance Measures*. Montvale, N. J.: National Association of Accountants, 1986.

Francis J. Walsh, Jr., *Measuring Business Performance*. New York: The Conference Board, Inc., Research Bulletin No. 153, 1984.

The general principles and problems of divisional financial performance measurement are covered in a number of books in the fields of management accounting and cost accounting. Two examples are:

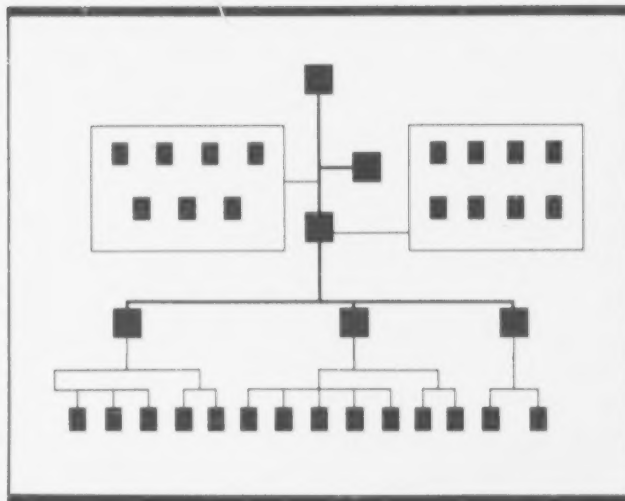
Gordon Shillinglaw and Philip E. Meyer, *Accounting: A Management Approach*. Homewood, Illinois: Richard D. Irwin, Inc., 8th Edition, 1986, Chapter 22, "Profit Reporting for Control."

Charles T. Horngren, *Cost Accounting: A Managerial Emphasis*. Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 5th Edition, 1982, Chapter 20, "Systems Choice: Division Performance Measurement."

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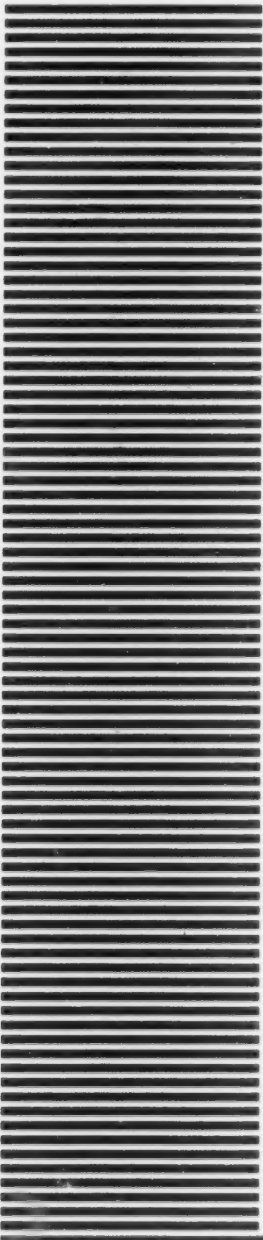
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Reshaping Financial Services

- *vigorous lobbying on deregulation*
- *industry consensus elusive*
- *debate pits large against small firms*
- *consumers growing querulous*

Summaries of Federal Legislation Currently Relevant To Financial Service Companies

The **McFadden Act** of 1927 prohibits national banks from branching across state lines and requires that they conform to the branching regulations of the state in which they are located.

The **Glass-Steagall Act**, or the Banking Act of 1933, was passed following a series of Depression-era bank failures. Under the Act, commercial banks are prohibited from underwriting and dealing in corporate securities; investment banks are forbidden to engage in commercial banking activities.

The **McCarran-Ferguson Act**, passed in 1945, provides a limited antitrust exemption for insurance companies (allowing them to share data in order to predict future losses and so on) and acknowledges the authority of the States to regulate and tax insurers.

The **Bank Holding Company Act** of 1956 defined a bank holding company and established the Board of Governors of the Federal Reserve System (the Fed) as the supervisor of such firms. The Act specifically defines the Fed's powers to review certain categories of bank holding company acquisitions, mergers and consolidations. Revisions to the Act in 1966 and 1970 redefined the word "bank," classifying it as an institution that accepts deposits withdrawable on demand (as well as making commercial loans). These changes also expanded the definition of bank holding company to include those that control only one bank and to allow bank holding companies to acquire interests in certain "nonbank" activities.

The **Securities Acts Amendments** of 1975 gave the Securities and Exchange Commission (SEC) a mandate to help develop a national market system for securities transactions and a system for clearance and settlement of these transactions. It reinforced a SEC ruling made earlier that year that struck down the use of minimum brokerage commission rates on securities exchange transactions. Prior to this legislation, fixed com-

mission rates had been in effect for over 150 years. Following this rate deregulation, many firms, including the affiliates of some bank holding companies, began to offer discount brokerage services.

The **Depository Institutions Deregulation and Monetary Control Act** of 1980 expanded the loan-making authority of savings and loans and mutual savings banks beyond mortgage lending, authorized automatic transfer services for banks, and negotiable orders of withdrawal (NOW) accounts for depository institutions. The Act authorized a phasing out of the Federal Reserve's Regulation Q by the end of 1986 (the regulation had set limits on the amount of interest commercial banks could pay on time deposits.) All depository institutions were made subject to reserve requirements (funds held against customer deposits) but they were also given access to Federal Reserve services such as check clearing and the discount window (borrowing privileges in order to meet temporary liquidity needs).

The **Garn-St.Germain or Depository Institutions Act of 1982** was aimed at helping depository institutions (especially thrifts) compete with the Money Market Mutual Funds being offered by securities firms. All depository institutions were authorized to offer money market deposit accounts which were exempt from the "Regulation Q" interest ceilings. Also, savings and loan and mutual savings banks were allowed to diversify their loans further away from mortgage lending, putting them on a more equal footing with commercial banks. Federal depository insurance agencies (the FDIC and FSLIC, see pages 5 & 6) were also given expanded emergency powers to deal with "financially distressed" institutions.

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Reshaping Financial Services

by

Kathryn L. Troy

All businesses (and most consumers) are affected by the reshaping of the U.S. financial services industry. The process already influences the ways a company raises capital, manages assets, and structures benefit programs. Further changes may determine with whom a company does "financial" business, at what cost, and with what risk.

Recent changes have been more evolutionary than revolutionary, but for many the ultimate goal is a more integrated financial services system. Traditional distinctions between commercial, thrift and investment banks are eroding, as are regional and state boundaries. The ways in which the insurance business operates are also altering. Some financial services executives say that their firms are already positioned for what will be a very different marketplace. "In the next 25 years there will be about 30 to 40 surviving financial institutions that can reach the consumer with all the necessary products, manufactured and serviced under one roof. These giants will be surrounded by numerous specialty houses," says an executive in an insurance firm that has now diversified.

But even as their vision of their industry takes a more substantial form, executives in many major banking, insurance, securities and commercial firms find that its full realization continues to elude them. Regulatory barriers at state and federal levels present one obstacle. (See box.) Yet, deregulation is certain to bring some dislocation and may result in hardship for smaller companies. "The struggles in financial-service deregulation seem to be lining up big companies against small companies, not insurance or securities firms against banks," says a government-affairs executive in a major firm. "At the state level, the small firms are still potent, but at the federal level the big ones are starting to exert influence."

How quickly will the structure of the industry change? The 100th Congress is considering new banking-industry legislation; a new Chairman, Alan Greenspan, is scheduled to take over at the Federal Reserve Board by Fall, 1987. Observers in-

side and outside financial services companies wonder whether regulatory change and a restructuring of the financial system will be underway before the 1990's.

This study profiles major issues in this industry, outlines areas likely to change most dramatically, and examines their significance to the way companies and consumers do business. The report was compiled from questionnaire data as well as interviews with government-affairs executives in 70 major financial services companies. Relevant documents and publications were also reviewed!

Federal Legislation: Regulate, Deregulate or Just Wait?

Pressure has been building for Congress to revamp the structure of financial services in the United States. The question is how to effect that change. The interests of large and small companies in banking, insurance, and securities (as well as diversified commercial companies with financial services subsidiaries) often conflict. Companies cannot accept *piecemeal* solutions—a benefit bestowed on one group often penalizes its competitors. Yet, financial services executives have difficulty agreeing on a recipe for *comprehensive* reform of the system. (See Table I for details on how financial services firms are lobbying.) The questions under debate involve significant alterations in the way financial instruments are handled. Major challenges to legislators, regulators and the courts include these:

- Should banks be allowed to underwrite securities, insurance and/or offer a range of real estate services?
- Should nonbank companies be allowed to offer traditional banking services, such as accepting deposits that may be withdrawn on demand or making commercial loans?

¹A detailed Conference Board report on public affairs in the financial services industry will be in print shortly.

Table 1: Regulatory Issues: Direct Lobbying by Financial Services Companies¹

Issue	Sector ²	Federal Level		State Level	
		Number of Companies	Percent Lobbying Directly	Number of Companies	Percent Lobbying Directly
Maintaining laws/regulations preventing expansion of commercial banks into securities underwriting or insurance	I,S	29	60 ^a %	21	50 ^a %
or					
Changing laws to allow banks into:	B				
Securities underwriting		31	85	13	70
Insurance		31	75	18	60
Changing laws and regulations to allow nonbank banking	B	31	60	19	30
	I,S	32	50	19	40
Changing laws and regulations to allow interstate banking:	B				
Within specific regions		22	60	28	70
Nationwide		28	45	23	40
In special cases		28	45	24	40
Repeal of the McCarran-Ferguson Act	I	26	60	12	60
Legislation/regulation to allow demutualization of companies ³	I	21	20	22	45

¹Direct lobbying includes independent activity as well as participation in efforts by ad hoc coalitions or business organizations. Those firms not engaged in direct lobbying are either monitoring the issue or relying on their trade association to lobby for them.

²Key: B = Banking; I = Insurance; S = Securities and Diversified Financial

³Mutual insurance companies are owned by their policyholders. In recent years, some mutual companies have sought state permission to "demutualize" and convert to a stock company. States such as New York, Alaska and Hawaii prohibit such conversions; other states provide guidelines to insure that such conversions are in the best interests of the policyholder; while still other states have yet to address the issue.

^a Percentages are rounded.

- Should banks be allowed to expand operations through acquisition or branches across state lines, within specific regions, or nationwide? At what pace?

- Must the risk incurred by financial institutions be subject to greater regulatory oversight?

Through the Loophole

To some extent, experts note, the industry's traditional barriers have already begun to erode, even if they have not been formally dismantled. Talk of exploiting legislative "loopholes" is common in the financial services industry. (See box.) Banks have tried to enter insurance through the "South Dakota" loophole and to sell securities through loopholes in the Glass-Steagall Act. The Bank Holding Company Act has not prevented banks, nonbank-financial companies (such as Travelers, John Hancock, and Merrill Lynch) and even diversified companies (such as Sears) from setting up limited-service, or "nonbank" banks. As regulatory agencies and the courts struggle with the issues raised by these developments, financial companies have been lobbying at the federal level—often with conflicting agendas. Some want to have the loopholes closed; others want a broadening and redefinition of

powers for their sector—or for all the players in the financial services arena.

Trade Association Role

The battle lines among the sectors of the financial services industry have been given clear definition at the trade association level by such groups as the Securities Industry Association (SIA), the Independent Bankers Association, the American Council of Life Insurance (ACLI), and various insurance underwriter (agent) groups. Small bankers, such as those who are members of the Independent Bankers Association, see limited-service banks as a serious competitive threat. For securities brokers, insurance agents and many insurers, the prospect of competing with their local banks is similarly threatening.

The existence of limited-service banks as well as the push by big banks for national banking have produced a schism within banking's major trade group, the American Bankers Association. Small banks oppose any federal law authorizing nationwide banking because they fear that the large multinational banks will devour them and destroy the character of community banking. Instead, they prefer a state-by-state or

regional approach that will give small banks a grace period. That would allow them to consolidate with other small or regional banks before the large "money-center" banks could make acquisitions or branch into their state.

The Legislative Score Card

No major new financial-industry legislation has been passed at the federal level since 1982. Although many insurance and securities executives believe this is a good thing, some exasperated banking executives blame Congress for ducking its responsibilities in the banking area. "From a large bank's viewpoint, there has been an increase in attempts at regulation, including those to increase reporting, capital and reserve requirements," says a government-affairs executive. "There have been regulatory rulings that allowed us into certain areas we were not in before. But Congress has done nothing whatsoever to deregulate the banking industry. . . Congress must recognize that it has set up a protective pond in which the securities industry may fish without competition."

In 1984, 1985 and 1986, Congress did formulate banking legislation, but the Senate and the House were unable to agree on a final bill. Fueling the 1987 legislative drive is the need to recapitalize the agency that insures savings and loan banks—the Federal Savings and Loan Insurance Corporation (FSLIC). Record numbers of failures among thrift institutions since 1984 have depleted its resources.

Meanwhile, bankers say that deregulation of the deposit side of their business has increased their cost of money and strained their profitability.² Full deregulation of banking would enable them to diversify their assets, increase their profits and spread their risk, bankers contend. Early in 1987, industry observers believed that prospects finally looked good for banks to get legislative approval of expanded securities powers—a major goal for which they have been lobbying aggressively. The Federal Reserve had granted some of these powers provisionally to a New York bank (see page 6). In a speech to the New York Banker's Association, the New York Federal Reserve Bank's President, E. Gerald Corrigan, proposed significant reforms that would extend the powers of both banks and securities firms. Still another early 1987 milestone was the formation of a new coalition of financial services companies, the Mayflower Group. With members drawn from companies such as Citicorp, American Express, Sears, Merrill Lynch and John Hancock, the group's agenda is broader than "banking deregulation"—it is pressing for a restructuring of the financial services industry.

By late March, 1987, the immediate outlook for deregulation of banking seemed less than promising. The Senate approved a banking bill that would recapitalize the FSLIC. However, the bill also placed a moratorium on expanded powers for banks (in securities, insurance and so on) and on the creation of new limited-service banks, although the 166 exist-

²In March, 1987, the FDIC reported that the total income of federally-insured commercial banks had declined by 1.4 percent in 1986—the first decline in 25 years. The Agency's Chairman tied most of the decline to loan losses due to continuing problems in agriculture and energy. In May, 1987, a Federal Reserve Study reported that an unusually high percentage of 1986 bank profits come from the sale of securities rather than from interest on loans.

Legislative Loopholes

South Dakota Loophole: In 1983, the state of South Dakota enacted legislation that allowed state-chartered subsidiaries of bank holding companies to engage in all facets of the insurance business. Insurance is basically state-regulated, and many insurance agents and companies want to discourage other states from passing legislation that would open similar loopholes. Thus, insurers have campaigned for national legislation to prevent state action. Connecticut's Senator Christopher Dodd offered an amendment to the "Garn Bill" passed by the Senate in 1984. The amendment would prohibit states from allowing state-chartered banks to sell insurance within their jurisdiction. The bill never became law, but the insurance industry continues to support the "Dodd Amendment" and hopes to keep it alive for future legislation.

Nonbank Bank Loophole: Under the Bank Holding Company Act, a bank is an institution that makes commercial loans and accepts deposits that are withdrawable on demand. Limited-service institutions may skirt this definition by offering NOW accounts, which technically do not give depositors the legal right to withdraw upon demand; or they may not take deposits but may make loans, offer credit cards, and provide other financial services. By some variation on this strategy, they manage to be "nonbank" banks. Companies such as Sears, Travelers, Merrill Lynch and John Hancock have such operations and have an interest in keeping the loophole open, while small banks see a competitive threat and are adamant about closing it. Larger banks generally favor keeping the loophole open, either because it gives them a possible vehicle for expansion across state lines, or because they see it as a bargaining chip that may be useful when negotiating other legislative concessions.

Glass-Steagall Loophole: Although the Glass-Steagall Act prohibits banks from trading and underwriting corporate securities, several major banks have maneuvered around the prohibition. They have been backed by their regulatory agencies, but challenged in the courts by the Securities Industry Association (the SIA). Many of the recent court and regulatory rulings have favored the banks. The securities industry continues to fight for legislation that would close the loophole, while banks are pressing for an even greater expansion of powers in the securities area (municipal revenue bonds, mortgage-backed securities and so on). (See pages 6 and 7.)

ing institutions could continue to operate. There are consumer measures as well: Banks would be required to give customers access to the money they deposit by check within six or seven days and to cash government checks without a service charge. (The presenter would have to have an ID card issued by the bank.)

By July, 1987, a House-Senate conference committee agreed on comprehensive banking legislation. But the Reagan administration opposed several provisions in the conference bill, and threatened a Presidential veto. Late in the month, administration officials struck a compromise with the chairman of the Senate and House banking committees. There were three key elements: The FSLIC recapitalization would be raised from \$8.5 billion to \$10.8 billion; regulatory leniency for troubled thrift institutions would be phased out after three years; and both financial and commercial firms would be allowed to ac-

quire insolvent thrift institutions that have assets of \$500 million or more. Controversial provisions that remain intact are (1) a ban on the establishment of new limited-service banks and (2) a temporary ban (until March, 1988) on any new regulatory rulings that would authorize expanded powers for banks. The bill must still be cleared through the House Rules Committee and approved by members of the House and Senate. Although the bill slows the Reagan Administration's campaign for deregulation, the President is expected to sign it—if it survives in its present form.

Regulators and Courts Fill the Gap

Limited-service banking, securities powers for banks, and expansion of banks into insurance are issues that have also been contested in the courts and by the bank regulatory agencies. The Reagan Administration favors further deregulation and has reportedly encouraged regulatory agencies to find legal interpretations and make rulings to promote this end. The Federal Reserve Board (the "Fed"), which is responsible for overseeing the state banks that are members of the Reserve System, as well as bank holding companies, has probably been the most conservative in its interpretations. Yet it has leaned toward giving broader securities powers to banks. It may favor deregulation more strongly with Alan Greenspan as its Chairman, according to many.

The other two agencies involved in banking regulation have been more lenient in their stance—at least on some issues. These include the the Office of the Comptroller of the Currency, which has primary responsibility for nationally-chartered banks, and the Federal Deposit Insurance Corporation. The FDIC shares with state banking authorities supervision of state-chartered banks that are not members of the Federal Reserve System but are covered by federal deposit insurance.

Commercial Paper and Other Securities

Probably the biggest issue that has faced the courts and regulators of banking practices has been the banking industry's drive into securities markets. The SIA which has brought many suits, has had victories in the lower courts. Decisions in appeals to the higher courts have generally favored the banking industry. These are the outcomes of some recent court decisions:

- As of December, 1986, courts have ruled that a bank may place but not underwrite commercial paper (short-term, unsecured corporate debt). Interpretations to date indicate that a bank may act as an adviser or agent for a corporation making an offering but may not purchase the paper or some unsold part of the offering for later resale to interested customers. This battle dates back to the late 1970's when the Federal Reserve was first asked to bar placement of commercial paper by Bankers Trust Company. At the time, the Fed ruled that commercial paper was not a security, but this interpretation was negated by a September, 1984, Supreme Court ruling. Saying that commercial paper is a security, the Court asked the Fed and a lower court to decide whether Bankers Trust's activity constituted underwriting under Glass-Steagall. The Fed ruled in favor of Bankers Trust, but in early 1986, a Federal

District Court found in favor of the SIA, saying the activity is a violation of Glass-Steagall.

A December, 1986, Appeals Court decision overruled the District Court decision and again cleared the way for commercial banks, but the SIA appealed this decision to the Supreme Court. In June, 1987, the high court refused to hear that appeal. Meanwhile a number of large New York banks are attacking on the regulatory front and have asked the Fed to allow them to underwrite commercial paper as well as to package and sell such other securities as municipal revenue bonds, mortgage-backed securities, and consumer-related loans. The agency sent several messages to Congress urging it to overhaul the Glass-Steagall Act and promised to rule on the New York banks' request by Spring, 1987.

As a first step, in March of 1987 the Fed ruled that Chase Manhattan Corporation may underwrite and deal in commercial paper through its commercial lending subsidiary. Late in April, by a 3 to 2 vote, it gave three bank holding companies (Bankers Trust New York Corporation, Citicorp and J.P. Morgan & Company) limited authority to underwrite and deal in municipal revenue bonds and mortgage-backed securities through subsidiaries. (J.P. Morgan also received permission to underwrite and deal in commercial paper.) Although he favors expanded securities powers for banks, the Fed's Chairman at the time, Paul Volcker, dissented from the ruling on the grounds that the agency does not have the statutory authority to grant banks these powers. The SIA announced plans to challenge the agency's ruling in a federal appeals court. Moreover, pending legislation could suspend the Fed's decision.

- Regulation of *discount brokerage* services offered by banks has embroiled the courts, the Securities and Exchange Commission (SEC), which oversees the securities industry, and the Comptroller of the Currency. As the name implies, discount brokers may buy and sell securities for customers at smaller commissions than full-service brokers, but they do not offer investment advice. As early as 1957, the Office of the Comptroller of the Currency (OCC) relaxed previous interpretations of Glass-Steagall that did not allow banks to receive a profit for brokerage transactions they made for the convenience of bank customers.

In 1982, the OCC went beyond this interpretation to say that banks could offer discount brokerage services to customers and noncustomers—provided this was done through a subsidiary. In July 1987, a federal appeals court upheld a 1986 decision by the Federal Reserve on a related matter. The Fed gave the subsidiary of the U.S. holding company of a London bank permission to offer both brokerage services and investment advice to institutional and wealthy clients.

There have also been questions about which agency should regulate the discount brokerage operations of banks. In 1985, the Securities and Exchange Commission moved to require banks engaged in discount securities services to register with the agency as broker-dealers, but a federal appeals court ruled in 1986 that the SEC had overstepped its authority. The decision was particularly important to small banks; a registration requirement would make it costly for them to enter this field.

Late in April, 1987, the SEC announced plans to ask Congress for the authority to regulate the securities operations of commercial banks. The SEC's position is that bank-brokerage activities should be conducted through separate corporate affiliates under that agency's oversight.

- Discount brokerage by banks has also been challenged by the SIA under the McFadden Act, which restricts the degree to which banks can establish branches. In 1984, the Supreme Court ruled that discount brokerage services of bank holding companies are not subject to the Act—clearing the way for many large banks to offer these services both inside and outside their home states. Early in 1987, the Supreme Court ruled (in *SIA v. Clarke*) that national banks, not just holding companies, may also operate discount brokerage outlets without being subject to McFadden Act restrictions, since these services are not “core banking activities.”

Interlopers in Insurance?

On the legislative front, the insurance industry has been protecting its turf by backing the Dodd Amendment (see box, page 5.) There is also regulatory and court activity. Generally, bank holding companies are limited to selling credit-related insurance products to bank customers, but there are exceptions. For example, sixteen bank holding companies are allowed to sell insurance nationwide because they established their operations before 1956, when the Bank Holding Company Act prohibited it.

Special provisions also apply in small communities: A Federal Reserve ruling allows bank holding companies whose principal place of business is in small rural towns (those with a population of 5,000 or less) to act there as a general insurance agent. The Fed recently amended this ruling. Now, a bank holding company or its subsidiary may act as a general insurance agent using lending offices in communities of 5,000 or fewer residents. (Such a community does not have to be its principal place of business.) It may also solicit insurance business from outside the small community, provided it conducts transactions from its office there. Trade associations representing insurance agents have filed suit on this ruling and await a hearing.

In the meantime, the Comptroller of the Currency issued a ruling authorizing a bank in Oregon to sell insurance both inside or outside the state. (The bank or its branch must be located in a town of 5,000 or fewer people.) Many in the insurance industry view this as an open door through which banks will establish branches in small towns with the intention of using them to sell insurance nationwide. Several insurance trade groups have filed suit on this ruling, claiming the decision violates the National Bank Act and the Bank Holding Company Act.

Yet banks and insurers are also involved in cooperative arrangements. In a 1986 survey by the Life Insurance Marketing and Research Association, 54 of its 253 responding members reported that they have marketing arrangements with banks or savings and loans. A handful of companies (12 insurers and 2 independent agencies) had cooperative arrangements in which they sold insurance in bank lobbies.

Limited-Service Banks

With banks making incursions into their territory, insurance companies and securities firms have looked to the “nonbank” bank as a way to widen their powers. Large banks have seen them as one means to establish a toehold in states where they are not otherwise allowed to branch. Only a large handful of nonbank banks were in operation before 1985, when small-bank trade groups and other organizations in Florida were successful in getting a district court to issue a preliminary injunction prohibiting the Comptroller of the Currency from chartering additional nonbank banks. Several hundred companies have applied for such charters.

Federal Reserve Chairman Paul Volcker has opposed nonbank banks, partially because the diverse interests of a commercial parent company might prejudice the loan decisions of a banking subsidiary. The Fed attempted to extend one of its regulations in order to give itself jurisdiction over limited-service banks and curb some of their activities. This move was invalidated by an appellate court in 1984, and in January, 1986, the Supreme Court ruled that the Fed had exceeded its authority (*Board of Governors of the Federal Reserve v. Dimension Financial Corporation*). The Court noted that new legislation would be necessary to regulate nonbank banking.

In another case, the Supreme Court also ruled against a lower court decision that had challenged the charter of a limited-service bank in Florida. A New York firm, U.S. Trust Corporation, had obtained the charter from the Federal Reserve in 1984. The State of Florida, the Florida Bankers Association, and other groups sued the Fed, saying that granting the charter was a violation of the Bank Holding Company Act. In a May, 1985, decision the U.S. Court of Appeals for the 11th Circuit in Atlanta said that, although not technically a bank, the nonbank entity was a bank for all intents and purposes. However, early in 1986 the Supreme Court vacated that decision. It suggested that the lower court review its ruling, taking into account the high court's decision in the *Dimension Financial* case.

Late in 1986, the 11th Circuit Court reversed its 1985 decision and upheld the charter of the New York company's nonbank-banking operation. The Conference of State Bank Supervisors and the Florida Department of Banking and Finance appealed the 11th Circuit Court's 1986 decision to the U.S. Supreme Court. In April of 1987 the high court refused to hear the appeal (*Conference of State Bank Supervisors v. Board of Governors*).

Large diversified financial companies and trade groups such as the American Financial Services Association have hailed these decisions as victories. No new nonbank-banking charters can be issued by the Comptroller of the Currency, however—the Comptroller's office is still under a preliminary injunction from a Florida district court. Late in 1986, the Comptroller petitioned to have this injunction removed, and it awaits the district court's decision. Moreover, proposed federal legislation would place a ban on new limited-service banks.

Too Much Risk; Too Little Responsibility?

Despite movement toward deregulation, the activities of

Table 2: Safety and Soundness Issues: Direct Lobbying by Financial Services Companies¹

Issue	Sector ²	Federal Level		State Level	
		Number of Companies	Percent Lobbying Directly	Number of Companies	Percent Lobbying Directly
Risk-based capital reserves (higher levels of reserves to be set aside for risky loans)	B	30	60a%	16	30a%
Risk-based premiums for FDIC insurance . . .	B	30	60	15	30
Accountability for off-balance-sheet liabilities (bank guarantees, loan commitments)	B	29	60	16	25
Restrictions on bank use of market instruments such as swaps and commercial paper	B	28	45	15	20
Increased reserves to be set aside to cover insurance losses	I	22	50	21	55
Adoption by states of legislation based on a Model Guaranty Association Act	I	19	40	25	65
Laws and regulations dealing with the activities of financial planners	I,S	29	7	24	20

¹See Table 1, note 1.^a Percentages are rounded.²Key: B = Banking; I = Insurance; S = Securities and Diversified Financial

banks, insurers and securities firms are under increased scrutiny. Legislators and regulators question whether insurers should be placed more completely under federal antitrust laws, whether financial planners need greater oversight, whether corporate takeover fever has led to abuses of the securities laws, and whether banks are risking too much in their quest for improved profits.

Safety and Soundness in Banking

In 1984, the imminent failure of Chicago's Continental Illinois Corporation (a bank holding company) brought the FDIC into the banking business when it purchased a large portion of the corporation's stock and installed a new Board of Directors. Small banks wonder whether they would be accorded the same treatment or allowed to fail. The controversial move helped bring to the surface banks' concerns about their share of FDIC insurance. Why should the premiums of well-managed banks increase as more banks fail, they argue—why not make premiums risk-based? This issue has inspired coalition lobbying among more than half of the companies surveyed for this study (See Table 2 for information on lobbying related to safety and soundness issues).

Regional economic slumps in oil, farming and real estate sales—as well as third-world loan problems—continue to hurt the banking industry. After a record 145 bank failures in 1986, the Chairman of the FDIC warned that in 1987 the fund might record the first loss in its 52-year history. Just over 50 federally-insured banks failed in the first quarter of 1987. Added to this are about 400 seriously insolvent thrift institutions that are taxing the depleted resources of the FSLIC. Regulators are at work trying to match failing banks with healthy institutions in other regions of the country and to facilitate acquisitions. To sweeten

the package for the acquiring bank, the FDIC is offering special interest-earning notes. The Fed is also considering the elimination of some of the barriers between an acquiring bank holding company and an insolvent thrift it acquires—allowing joint marketing and sales, joint advertising, and the like. (Acquisition of a failed bank is one method large banks have used to get access to markets in states where they are not otherwise allowed to operate.)

While those who favor deregulation point to increased competition as a good that will benefit both the industry and the public, some observers take a less rosy view. They believe that competition is forcing banks to pay artificially high interest rates to attract deposits. With their cost of money so high, observers say, banks are making increasingly risky investments in order to maintain an acceptable level of profit. The Fed, the Comptroller of the Currency, and some legislators have suggested that the reserves that banks must set aside to cover losses be based on an assessment of the level of risk in their portfolio of assets. For example, loans to third-world countries would require higher levels of reserves than investments in money market instruments such as government securities.³ Such risk-based capital requirements would have a major effect on large banks—over half of the banks participating in this study report that they are active in coalitions lobbying this issue. (Whether they oppose it or favor it depends upon their size and the level of risk in their portfolio.)

³In May, 1987, Citicorp announced that it would add \$3 billion to its loan-loss reserve to provide for possible shortfalls in loan repayments by third-world countries. Although this means that the firm will register a record \$2.5 billion loss for its second quarter, industry analysts see the move as an attempt to put third-world debt problems behind the bank and to strengthen its competitive position. Several other major banks have followed the Citicorp lead.

Off the Balance Sheet

In the meantime, the search for profits among large banks has created other quandries for regulators. Banks are acting as middlemen: they make commitments in which they agree to step in and complete a deal if one of the participants should default; they engage in "swaps" of foreign currency for dollars (or vice-versa); they likewise swap fixed for variable interest rates; they offer standby letters of credit which guarantee that a client purchasing goods will make payment.

Usually, banks have to make good on only a portion of these commitments, so they treat them as "contingent liabilities." Actual assets and liabilities need to be accounted for on the bank's balance sheet—and these are used by the Fed to calculate the level of capital reserves the bank must maintain. The "off-balance-sheet" items escape that treatment.⁴ The Fed is examining this situation, hoping to devise a fair method for requiring sufficient capital reserves by banks to cover their risk adequately.

Buyouts and Insider Trading

As reports of growing numbers of acquisitions, mergers, leveraged buyouts, or threatened takeovers by "corporate raiders" escalated in 1985 and 1986, members of Congress began to wonder whether current laws were being abused and new legislation was needed. More than 60 separate takeover bills were introduced in the 99th Congress, but each had only a few sponsors and there seemed to be no consensus about what action should be taken. In 1986, the SEC prosecuted participants in a major insider-trading scandal. Late in the year, it dropped a new bombshell: Ivan Boesky, the best known of the New York arbitrageurs (investors who commit large amounts of capital to purchase the stocks of companies that may announce a major deal, such as a merger) had admitted to trading on insider information and implicated others on Wall Street. This revelation seemed to confirm the worst fears of some in Congress that such abuses may be widespread and need to be curbed. Senator Proxmire, head of the Senate Banking Committee in the 100th Congress, is promising to hold hearings on the subject and is reported to be considering various legislative options.

The SEC, backed by the securities industry, maintains that it has adequate powers to curb such abuses. Nevertheless, as new abuses continue to be unveiled in the early months of 1987, pressure mounts for the agency to (at the very least) develop a better definition of insider trading. Some observers are calling for much broader action, fearing that the widening scandal might develop into a backlash against all of corporate America, or at least its investment banking firms.

Financial Planning

Congress has also been questioning the SEC's ability to regulate another segment of the financial industry—the fast-growing profession of "financial planning." There are vary-

ing estimates of the total number of individuals offering these services, but included are some 10,000 investment advisers registered with the SEC (up from 4,000 five years ago) and an estimated 50,000 to 60,000 personal financial planners (up from a few thousand in 1981). Investment advisers have been required to register with the SEC since the passage of the Investment Advisers Act of 1940; their turf has generally been restricted to advice about securities and similar investment options. Financial planners provide similar services but also give advice in other areas such as insurance, taxes or real estate. Most states require that financial planners register with them, but there is little uniformity in their laws and requirements.

In the recent past, advice given by some in the profession has been suspect (investors may be encouraged to buy stocks in which the adviser has a financial interest) or even criminal—in one notorious case, clients were urged to invest in a fraudulent tax shelter that involved sales of meat and pelts from a "super rabbit."⁵ Concerned that the SEC was not effectively policing the growing ranks of planners and advisers, a Congressional subcommittee held special hearings in mid-1986. The SEC, the securities industry and groups representing insurance agents (whose activities sometimes meet the definition of financial planning) resisted the notion that additional legislation is needed. The latter two groups also reject a proposal of one professional association that the industry establish new self-regulatory bodies. Rather, they support stronger enforcement of existing regulations and more federal/state cooperation. No Congressional action was taken in 1986, but observers say that the issue did not die with the 99th Congress. About 20 percent of the insurance and securities companies participating in this study worked in coalitions to lobby on this issue, while almost 40 percent saw it as an issue to be addressed by their trade associations.

Crisis, Competition and The McCarran-Ferguson Act

Insurance companies are primarily state regulated, but during 1986 there was concern at the federal level due to what were perceived as problems in the pricing and availability of liability insurance. Although the issue most directly involved property and casualty insurers, sufficient legislative activity took place so that the status of insurers in general came into question. Bills which would have repealed, (or in the case of another bill, restricted) the McCarran-Ferguson Act were suggested. The act, in force since 1945, exempts insurance companies from many of the provisions of federal antitrust law, allowing firms, for example, to pool information. This sharing of data enables insurers to better predict losses, establish actuarial standards, and set rates.

Those advocating repeal of the McCarran-Ferguson Act say that under the current law the public is not adequately protected against price-fixing by insurance companies. Insurers point to the plethora of state regulations to which they adhere and believe that repeal of the exemption would cause dislocations in the industry and force many small companies out of business, thus decreasing competition.

⁴For more information, see Robert A. Bennett, "Worrisome Bank Obligations." *The New York Times*, June 27, 1985.

⁵See Gary Weiss, "Financial Planners: Do They Need Greater Regulation?" *Barrons*, March 11, 1985.

Competition's Impact on Rates and Availability

Some industry observers argue that competition is what undid the property and casualty industry in the early 1980's. At that time, they say, interest income on investments was in the double-digit range and competition for resources to invest was intense. To attract customers and funds, critics contend, some property and casualty insurers reduced their premium rates for commercial coverage. High rates of return on investments compensated for any losses sustained on their payouts on new policies.

But during 1985 and 1986, as interest rates fell, companies reevaluated their underwriting practices. Some refused coverage to high-risk clients and made increases in the rates charged to those clients they continued to cover. Predictably, cries of pain and outrage arose from those individuals, businesses, municipalities and services affected. But some property and casualty insurers and businesses pointed to the rise in liability litigation and to the evolving status of the civil justice system represented by state-level changes in tort liability. Insurers pointed out that large increases in the number of claims litigated, as well as the escalating size of awards made by courts, had to be dealt with in setting prices for liability coverage.⁶

The Push for Tort Reform

There has been a flurry of activity at the state level supported by the business community and insurers. And during the past few years, varying levels of tort-reform legislation have been passed in an about 40 states. The Administration introduced a package of three federal tort-reform bills in Spring, 1986, but these were not passed in the 99th Congress. Members of the House and Senate also introduced a variety of bills, including one that would establish a Federal Insurance Commission, but no action was taken.

Observers inside and outside the insurance industry point out that the liability crisis has activated industry opponents who wish to charge insurers with using the "tort reform" issue to camouflage the industry's cyclical problems. To some extent, this wave of opposition has helped to fuel new legislative proposals in the 100th Congress to review the antitrust provision of McCarran-Ferguson. Not surprisingly, more than half of the insurance companies participating in this study report they are active in coalitions that address the McCarran-Ferguson issue (Table 1).

During 1987, the 100th Congress began new hearings on tort reform, and new legislation has been introduced. Insurers are placed in a difficult political position because there is a possibility that amendments to a tort reform bill might carry with them greater federal oversight of insurance or modification of the McCarran-Ferguson Act. In the meantime, tort reform measures in some states may prove to be a mixed blessing for insurers. In a case currently in dispute, the State of Florida linked tort reform to industry pricing by passing a law which gives the state the authority to review commercial liability rates.

⁶See "Property and Casualty Executives Speak Out." *Best's Review*, June, 1986. For a further discussion of related issues, see also: Nathan Weber, *Product Liability: The Corporate Response*. The Conference Board, Report No. 893, 1987.

Other states, such as Connecticut, are citing the failure of rates to decline following tort reforms as a rationale to rescind previously enacted reforms.

The Consumer: Still a Force

"The consumer ethic has been absorbed by the great mass of the American people," says First Interstate Bank of California's Vice President, Public Affairs. "Consumers are better able to articulate their demands, and expect fulfillment of promises and quality of service." Shawmut Bank's Vice President, Government Affairs remarks: "Today's consumer effort is more organized and sophisticated, but experience has also made us more sophisticated. It is already part of our business plan to address much of what they will come up with. They don't have to picket because they know that the communications lines are open—they can come in and talk to us."

In fact, many financial services executives note that it is good business to anticipate consumer demands. "It has become much more a marketing than a public-affairs issue," says Aetna's Vice President, Communications. "People talk about this business being 'market-driven.' Anyone who really means that will get out there and identify what customers want *before* they demand it." Executives at Sears' Dean Witter say this is just what they have done. "We generally start out with consumer research and try to meet a need before it becomes a consumer issue—we offer low-cost checking services at our savings banks and our credit card has no annual fee because consumers said that was more important to them than interest rates," says the company's government-affairs executive.

There is still some tension in the air, however. (See Table 3 for details on consumer issues on which financial services companies are lobbying.) In the insurance industry, consumer and other interest groups are challenging the fairness of the risk classification system used to establish the price of insurance premiums. Banks are being challenged on the level of interest rates on credit card balances and the limited availability of check-cashing and basic checking services to low-income individuals (such as the elderly or students).

Risk Classification. Insurers' Public Education Dilemma

A basic tenet of insurance is that the premium a customer must pay for coverage is determined by the risk he or she presents to the insurer. The insurance industry is discovering that the public does not always understand or approve of the use of risk classification to determine the price of its services. Two recent issues have demonstrated this. Both concern charges of civil-rights violations and discrimination—challenges that have come through the courts and in state legislatures. One controversy, apparently on the decline, is the issue of sex discrimination in insurance pricing, which has resulted in calls for "unisex pricing." The other, yet to be resolved, is the use of blood tests in determining eligibility for life or health insurance coverage. The specific focus of the dispute is whether insurers may test to determine the presence of antibodies to acquired immune deficiency syndrome (AIDS) in the blood of a prospective insured.

Table 3: Consumer Issues: Direct Lobbying by Financial Services Companies¹

Issue	Sector ²	Federal Level		State Level	
		Number of Companies	Percent Lobbying Directly	Number of Companies	Percent Lobbying Directly
Risk Classification:					
Laws/Regulations requiring that insurance companies provide unisex coverage	I	26	70 ^a %	26	75 ^a %
Efforts to prevent use of special medical tests to determine risk of insuring potential customers (e.g., the AIDS antibody tests)	I	23	70	24	80
Laws/regulations to allow caps on health coverage for expensive medical procedures (e.g. dialysis, organ transplants)	I	24	20	22	45
Cost:					
Affordable banking services for low-income customers	B	20	50	25	70
Efforts to make insurance more widely available to low-income customers	I	22	20	26	40
Regulation/capping of credit-card interest charges	B	30	70	28	70
Closer alignment of bank charges for consumer credit, business loans and mortgage rates to interest paid to depositors	B	27	45	25	45
Repeal of anti-rebating laws	I	20	30	24	55
Disclosure:					
Increased disclosure/public posting/explanation of bank fees, service charges and availability of funds to customers	B	27	50	26	50
Efforts for greater disclosure of prices/costs of insurance to consumers	I	22	20	26	40
Service:					
Establishing a standardized check-holding policy (to govern the period before funds are available to the depositor)	B	28	80	21	70
Calls for improved claims service	I	21	25	27	40

¹See Table 1, note 1.

²Key: B = Banking; I = Insurance; S = Securities and Diversified Financial

^a Percentages are rounded.

¹See Table 1, note 1.²Key: B = Banking; I = Insurance; S = Securities and Diversified Financial^a Percentages are rounded.

Unisex Coverage

Traditionally, women have paid lower prices for auto and life insurance because insurance data show that they have fewer accidents and live longer than men. However, insurers claim that women are more likely than men to make claims on their health and disability insurance policies (for example, due to pregnancy). Often, they are charged higher rates than are men for individual coverage of this type. Individuals and groups such as the National Organization for Women (NOW) have challenged this practice in the courts. There was a flurry of legislative activity related to the unisex coverage issue throughout 1984 and 1985. During that period, insurers mounted a vigorous state level effort to educate legislators and the pub-

lic through media campaigns, direct lobbying, presentation of local workshops, and similar grass-roots efforts. Although a handful of states have legislation barring sex discrimination in setting rates for *auto* insurance, to date only one, Montana, has passed comprehensive legislation barring sex discrimination in setting rates for *all* lines of insurance.

AIDS: A Test

The unisex issue is not dead, but activity subsided in 1986, even as discussions over AIDS and insurance coverage heated up. Insurers contend that just as they use medical test data to assess their risk in insuring people with ailments like diabetes, cancer or heart disease, they must avail themselves of

test data that indicate whether a candidate has a high risk of developing AIDS.

Their critics contend that use of the AIDS antibody test is unfairly discriminatory and in conflict with basic individual human rights. Not only might a positive test result mean that an insurance candidate is rejected, but results could be passed on to others, such as employers, and become the basis for other forms of discrimination. Moreover, since large proportions of AIDS victims are male homosexuals, gay-activist groups have accused the insurance industry of discriminatory practices other than requiring the antibody test. They allege that insurers or their investigators have used home zip-code data and other methods to "weed out" male insurance applicants whom they suspected of being homosexual and thus at high risk of contracting AIDS.

Recently, legislative hearings over the AIDS antibody testing issue have been held at the federal level and in a number of states. Wisconsin, California and Washington, D.C. have passed laws restricting the use of the AIDS antibody test to screen prospective policyholders. Several other states have developed guidelines for insurers. Late in 1986, state insurance commissioners, working through the National Association of Insurance Commissioners (NAIC) adopted a set of model regulatory guidelines. Developed by members of the insurance industry, gay-activist groups, and state regulators, the guidelines address the issue of discrimination but stop short of taking a position on AIDS antibody testing. Among other things, the guidelines would bar insurers from asking direct or indirect questions about a policy-applicant's sexual orientation and require that investigators be instructed to refrain from doing so. Insurers would be permitted to ask candidates about the results of a prior test for AIDS antibodies, so long as the state allowed such testing.

In the meantime, a recent opinion poll by the ACLI revealed that only 35 percent of the public supported the use of risk classification by insurers, compared with 57 percent in 1979. The trade group is launching a 1987 print and TV advertising campaign to give consumers a better understanding of the principle of risk classification and how it is used in the underwriting process.⁷

Service: Why Does It Cost So Much?

Currently, bank services, especially the rates charged for credit cards, appear to be a prime target for consumer activists. For insurance companies, the key issue on the cost and service front has been property and casualty coverage, but as that crisis wanes, questions about pricing are surfacing at the state level.

1987: The Year for a Credit-Card Showdown?

Since the deregulation of the deposit side of banking in the early 1980's, banks have had to compete for funds. While the rate of inflation remained high, the interest rates banks offered on some kinds of deposits kept pace, but so did the interest

rates they charged customers for credit cards and loans. With lower inflation by the mid-1980's, the rates on deposits dropped, but interest charges for loans and credit cards declined more slowly—in fact credit-card rates remained around 18 percent.

During 1986, the credit-card issue simmered at the state level, although only seven states actually passed legislation placing some kind of cap on the amount banks might charge. Connecticut, for example, capped the rate at 15 percent. Discussions have also taken place at the federal level, and early in 1987, new legislation calling for greater disclosure of card terms and the application of a floating cap to the rates was introduced in the 100th Congress.

Consumer groups have inaugurated their 1987 lobbying campaign with news conferences in six cities, calling for action by consumers: to discard credit cards from banks which charge high interest and apply for new cards at those banks which charge lower rates. Although banks admit that a lower rate of inflation has decreased their cost of funds, they contend that this is only one factor they must weigh in establishing interest rates for credit cards. Other factors include the costs of processing millions of small transactions and losses due to credit-card fraud. They argue that the credit-card issue has been manufactured by consumer groups. "Congressmen do not report receiving many letters on this issue from constituents. In fact in periods before key testimony on the issue, the number has been zero", says the government-affairs executive of a major bank.

Industry observers note that past studies show that customers do not seem to know what rates they are paying, but this may be about to change. As the 1986 Tax Reform Act phases out tax deductions for credit-card interest and lower interest-rate options become more plentiful, banks may have to compete or be left behind. New competition in bank credit cards may intensify the debate. In March, 1987, American Express announced plans to offer an "Optima" card to selected customers. Like the bank credit cards, Optima will offer revolving credit, but at a rate of 13.5 percent on outstanding balances. Sears also entered the credit-card fray about two years ago with its "Discover" card, pitched toward its middle-income customer base. Although the card's interest rate is above that of many bank credit cards, there is no annual fee.

Basic Banking Services

"Lifeline banking" is a term that makes bankers grimace, but the issue is one that continues to receive attention from legislators and regulators. Before deregulation, charges for checking accounts or check-cashing privileges were minimal. With competition, bankers say, their costs increased and they had to charge more for basic services. Sometimes the service fees were steep, more than low-income customers could afford. Consumer advocates contend that banks have cut the "lifeline" of such groups as poor elderly people who have no place to cash their Social Security check or store the funds they will use to pay their bills. In early exchanges, banking executives pointed out that other check-cashing services existed, that

⁷News "Ad Campaign Will Focus on Risk Classification, *Best's Review* (Life and Health Edition), December, 1986.

postal money orders could be used to pay bills, and that banks were in the business of offering services, not entitlements.

As the discussion evolved, some banks realized that the "life-line" issue was developing broader connotations—critics were asking questions about banking's "public trust." A number of banks have developed a package of basic banking services, which may include checking with minimal fees (but paying no interest) or no-fee checking with a limited number of deposits or checks (combined with some other basic services such as check-cashing privileges and availability of money orders or cashiers' checks.) In 1986, the Federal Reserve developed a set of recommendations for basic banking. The guidelines must go through several additional approval levels, and compliance will be voluntary. Nevertheless, they are expected to have clout among the state-chartered banks regulated by the Fed. Bankers generally oppose regulation in this area; about half of the banks participating in this survey report lobbying on this issue at state and federal levels. Just under a quarter say they have a service for low-income customers.

Insurance Pricing and Anti-Rebating Laws

Another cost issue has attracted lobbying attention from insurance companies that do business in states such as California and Florida, where anti-rebating laws are under challenge. In effect, anti-rebating laws forbid insurance agents to lower the price they charge certain customers for insurance coverage through "rebating," or passing on part of their sales commission to a customer. Anti-rebating laws were passed in many states early in the 1900's at a time when intense competition among agents resulted in unethical sales practices and outright fraud. Those who support attempts to do away with these laws believe that healthy competition among agents will decrease the cost of insurance. Those who oppose repeal of the laws argue that they continue to protect consumers from the unscrupulous practices that were prevalent at the turn of the century. Industry observers believe that insurers may face challenges on the anti-rebating issue in additional states, as consumer groups put more pressure on companies to lower prices.

Adequate Disclosure and Service

Calls for more complete disclosure of service-initiation charges, fees, interest rates, and other information have created issues for both banking and insurance companies. Consumer groups are charging that banks do not make sufficient information available about account features such as deposit and loan rates, interest-charge calculations, and opening and minimum check balances so that customers can "comparison shop" among banks. Many banks say that they have increased their disclosure: "On the one hand, consumer groups tell us there should be more disclosure—on the other hand, they tell us that there is so much advertising that it is confusing," says one government-affairs executive. Regulatory agencies say that they are studying bank advertising and disclosure practices, using an interagency working group convened by the Federal Reserve Board.

Disclosure is not as strong an issue for insurance companies today as it was a few years ago, when the NAIC developed model regulations. Critics of the industry say it is still very difficult for consumers to compare policies and that NAIC guidelines recommended for life insurance in 1976 and revised in 1983 constitute "pseudo disclosure."¹ As with banking executives, many in insurance say that this is an issue generated by consumer activists, with very little grass-roots backing.

Adequate service is a perennial consumer concern. The key current issue is the question of how long banks take to clear a check and make funds available. Consumer groups say that banks delay payment well beyond the period it takes to clear a check and that it is often difficult for customers to get information about a bank's policy on check clearance and "funds availability." Federal regulatory agencies say that current laws are adequate to address this problem, but that they are studying ways in which the current check-clearing system might be simplified. Banking legislation currently before the 100th Congress contains a provision on this issue. (See page 5.)

The State Level: Insurer Insolvency and Bank Expansion

In the banking industry, issues of risk-based capital and deposit-insurance premiums have sparked controversy at the federal level. Insurers face similar challenges at the state level. In question are the level of reserves that should be set aside to cover losses and what mechanism (if any) should be used to engage solvent insurers in rescuing customers of an insolvent insurance company. As state regulators wrestle with insurance problems, banks have offered new challenges to state legislatures and the courts. While Federal legislation that would allow banks to expand nationwide has been stalemated in Congress, there has been no lack of activity at the state level.

Risk and Insolvency in the Insurance Industry

The year 1985 was a bad one for property and casualty insurers, who reported \$5.6 billion in losses. Since early 1986, a number of insurers have raised property and casualty reserves to cover higher-than-expected future losses. Industry sources say that many of these losses may result from higher costs associated with increased tort activity. Late in 1986, the state of Texas reported that the number of insurance firms in receivership there had more than doubled in five years. Many of them were property and casualty insurers. Regulators in some states began to raise questions about the adequacy of insurers' loss reserves.

What happens to the customer's investment when an insurance company goes bankrupt? During the consumer movement of the early 1970's, state insurance commissioners, working through the NAIC, held that other insurers in the bankrupt company's state of "domicile" should be responsible. Some states formed guarantee associations through which insurers were assessed a set percentage of premium each year

¹See J.M. Belth, "The Continuing Plight of the Consumer." *Best's Review* (Life and Health Edition), August, 1985.

until the bankrupt insurance company's obligations to its customers had been met.

By the mid 1980's, a large bankruptcy (Baldwin United Corporation) and several other failures led some insurers to question the guaranty association procedures. One concern: Would solvent insurers be required to guarantee customers of an insolvent company the same above-market rates of return—rates which had contributed to the bankrupt company's downfall? Fears of crisis brought on by new insolvencies and escalating demands helped stimulate thinking among insurers and their regulators.

Working with consumer groups and the insurance industry, the NAIC devised a new Guarantee Association Model Act. Among its innovations is one making each state's guaranty association responsible for covering only *residents* in its own state. If a sufficient number of states adopt the legislation, this would spread the burden for the bailout, rather than placing it exclusively on companies in the state where the failed company legally resides. States without guaranty associations are being urged to review the model act for possible adoption; some states with guaranty associations may review the model and amend their current laws.

States' Rights and the National Banking Imbroglio

"Markets without products and products without markets make no sense," says the government-affairs executive of a large eastern bank. "We will continue to push for national banking and a full range of products or we can't compete." Federal laws permit a state to authorize the entry of out-of-state banks, so long as it enacts specific legislation to that effect. In the early 1980's, groups of banks in geographic regions around the country (usually contiguous states) helped develop the concept of regional banking "compacts." In effect, an individual state passes a law that allows banks from other specified states to make acquisitions within its borders, provided these states reciprocate. Other states in the region pass similar laws.

The compacts sometimes bar large banks from money centers such as New York and Chicago from acquiring banks in that state. This tactic reflects local concern that large, out-of-region banks might, through acquisition, become the dominant force in the "territory." In many cases, it was the larger, regional banks in each area that led the campaign. Smaller, community banks went along on the theory that a regional compact was better than full interstate banking.⁹

Regional Banking Compacts

New York banks seemed to be excluded most often from the compacts, and several, including New York's Citicorp, decided to test the legality of the compact in New England. An appeal to the Federal Reserve ended with the Fed supporting the

compact; a U.S. Court of Appeals in New York upheld the Fed's decision. The case was then appealed to the Supreme Court, which upheld the lower Court's decision (*Northeast Bancorp v. Board of Governors*) in June, 1985.

National banking legislation under consideration at that time would have permitted a five-year grace period before full national banking went into effect. This would allow time for banks to consolidate on a regional level before the huge outsiders could invade. But the Supreme Court decision made it unnecessary to provide this safeguard—the compact approach had already solved the problem. In the view of many medium-sized and small banks, national legislation was now not only unnecessary but even unwanted.

While national banking may be in limbo at the federal level, interstate and regional efforts proceed apace. More than 35 states allow banks from some other state or states to make acquisitions in their jurisdiction. A few states, including New York, Maine, South Dakota and Arizona, have laws that allow banks from any state to enter. (New York requires reciprocity; the others do not). California and Texas passed laws in 1986: California's allows entry by nonregional banks by 1990, but the Texas law had more immediate applicability. Late in 1986, Chemical New York Corporation became the first major bank to take the plunge by announcing a planned takeover of Houston's Texas Commerce Bankshares.

In the meantime, some banks have managed to expand geographically through "special-case" acquisitions of failed banks or thrifts. (See Box.) Bank regulators are seeking powers that would let banks acquire failing as well as failed institutions, and their holding companies. If the Comptroller of the Currency is again empowered to issue nonbank-bank charters, these will also be an avenue to geographic expansion. (See page 7.) Among the banking companies participating in this study, more than half have been actively lobbying on this issue at the state level (Table 1).

Many observers contend that the regional-compact era is transitional and point to the emergence of "super-regional" banks as one of the positive outcomes. These institutions—like First Union, NCNB and SunTrust in the Southeast, Banc One in Ohio, and Boston-based Bank of New England—have grown in asset size and capacity through mergers. A recent article noted that "super regionals" are less likely to be saddled with the third-world loan problems that have plagued the money-center banks; they are believed to be in a better position to tap consumer and middle-market corporate business. As such banks grow in size and sophistication, there is even some speculation that they foreshadow the demise of the money-center bank.¹⁰ Yet the pace of competition, along with product and service innovation by major banks, continues to escalate. Although there are confident predictions within the industry that national banking will become a reality during the 1990's, as yet few observers seem to be placing firm bets on the topography of the new banking landscape.

⁹Arizona may be an exception. According to press reports, small bankers in that state lobbied for national banking, hoping to get "the broadest possible market for their stocks". See Robert Bennett, "Interstate Banking's Difficult Birth," *The New York Times*, June 2, 1985.

¹⁰"Banking's Balance of Power is Tilting Toward Regionals." *Business Week*, April 7, 1986.

Focus on the Future

Whether the financial system is restructured quickly or evolves more slowly, businesses and consumers will see significant differences in the way they purchase and receive financial services. And the companies that provide these services will be under increasing pressure. Some of the hurdles that these firms, their regulators and legislators may have to overcome include:

- *Securities* firms must restore their industry's credibility in the wake of the insider-trading scandal. Companies may be able to satisfy their critics that they can reinforce the "Chinese Wall" that has traditionally separated investment banking and arbitrage. But some observers believe that stiffer regulation or new legislation will be required.

- Major *banks* have been in the forefront of the battle for deregulation. Will the banking industry be restructured and more completely deregulated?

- As commercial banks expand into markets formerly reserved for investment bankers and insurers, there are many questions about how to safeguard the safety and soundness of the banking system. Beyond issues of what will be permitted are decisions about what organizational structure would work best.

- Do bankers have an alternative to deregulation? Observers suggest that one or more major firms might challenge the system by dropping its federal charter and reorganizing, perhaps as a diversified financial services company.

- Some industry observers note that deregulation in the early 1980's removed so many of the barriers distinguishing thrifts from commercial banks that it no longer makes sense to divide the two. They wonder whether thrift institutions should continue to have a separate depository-insurance agency.

- A new wave of pressure on consumer issues may be in bankers' future. The Chairman of the Senate Banking Committee in the 100th Congress is reputed to be more consumer-oriented than his predecessor.

- *Insurers* seem likely to be challenged at both the state and federal level. Smaller firms are opposed to federal regulation of insurance, but larger companies that have diversified from an insurance base see possible advantages. Executives point out that federal bank regulators often speak out to defend that industry, but insurers have no such champion. Moreover, some diversified firms find state regulation of their insurance activities increasingly cumbersome.

- Questions about the fairness of insurance pricing, the industry's system for compensating insurance agents, and how industry competition affects the consumer will continue to challenge insurers.

The Versatile Thrift Institution

The "thrift" industry, which is made up of savings-and-loan institutions as well as mutual savings banks, is currently experiencing the best and worst of times.¹ While stories of failing thrifts and the depleted funds of the FSLIC continue to make headlines, probably as many as three-quarters of the nation's thrifts are solvent.² Many are quite profitable. Since their basic business is home mortgages and mortgage interest rates are fairly low, their business is booming as consumers buy homes or refinance their existing mortgages. This has made the thrift industry more attractive to commercial banks. Some, like New York's Citicorp, have purchased failed thrifts in California, Florida and Illinois, states where they are prohibited from acquiring commercial banks. Early in 1987, Citicorp also agreed to acquire 50 savings and loan branches in Southern California from Sears, when Sears decided to concentrate thrift activity in its stores.

More recently, other commercial banks have been trying to acquire healthy thrifts, with plans to convert them to full-service banks. Since that would take away healthy members of the beleaguered FSLIC insurance fund, regulators are reported to be looking for ways to avert such moves.

Still other thrift institutions are taking advantage of a new wave of investor interest by converting from mutual to stock companies. In some cases, stock is sold to the broad public; in other cases, it is purchased by a small group of investors. Some observers question whether the change in control will alter the basic mission of savings institutions—that of the "neighborhood-oriented housing lender."³

Thrifts have also set up shop in Sears and K-mart stores. Sears owns its thrifts, but K-mart has made a deal with a unit of Ford Motor Company. Ford's First Nationwide Bank (the country's 7th largest thrift) will set up kiosks in 150 K-mart stores during 1987. Among the services available at retail-store thrifts are home loans, Certificates of Deposit, charge cards, and routine checking or savings accounts.⁴

¹Technically, the term "thrift" also includes credit unions and industrial banks.

²In the current Congressional debate over the amount to be set aside for recapitalization of the FSLIC, thrift-industry executives are divided. Some believe that too large an infusion of funds may tempt regulators to liquidate troubled institutions in lieu of helping them achieve a profit turnaround. Others believe that a significant infusion of funds will help restore public confidence in the industry and ensure its long-term survival.

³See Eric Berg, "State Savings Banks Thriving," *The New York Times*, February 7, 1987.

⁴See "Attention Savers! K-mart Wants You," *Business Week*, January 19, 1987.

- Life and health insurers will be struggling to find constructive solutions to the dilemma of insurance coverage for potential victims of AIDS. Executives must find ways to protect their companies' profitability without provoking public accusations that they are insensitive.

- Property and casualty insurers will reap benefits from tort reform, but continued activity may bring higher costs as well.

- If they hope to participate in "banking" activities, *commercial firms* that diversify into financial services face a stiff challenge. They must convince legislators and regulators that there is a way to meld banking and commerce without serious threat to the nation's depository system.

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Corporate Venturing

- *growing phenomenon fraught with risk*
- *attractive returns, access to technology growth and diversification are principal lures*
- *U.S. venture capital investments now total \$22 billion*
- *but venturing is not for everyone*

Research Bulletin No. 214

Sources of Information

Much of the information for this survey came from the written responses of 154 senior officials of large, and for the most part, publicly owned corporations around the globe. Additional data was obtained through interviews with survey respondents and other knowledgeable executives.

Table 1 classifies 154 responding firms by geographic area and shows the percent of those involved in business venturing. Survey results demonstrate that levels of participation are virtually the same in the United States and in Europe. Of the 98 venturers there are 63 manufacturers, 24 financial service institutions, five utility or telecommunications firms, three retail firms, two transportation companies, and one mining company.

Table 1: The Venture Postures of 154 Surveyed Companies

<i>Domicile</i>	<i>Number of Respondents</i>	<i>Venture Participation</i>		<i>Percent Involved in Venturing</i>
		<i>Yes</i>	<i>No</i>	
United States	103	67	36	65%
Europe	41	27	14	66
Great Britain	13	8	5	
Germany	9	7	2	
Switzerland	6	4	2	
Holland	3	2	1	
France	2	2	0	
Italy	2	1	1	
Finland	2	2	0	
Sweden	2	0	2	
Belgium	1	0	1	
Norway	1	1	0	
Elsewhere	10	4	6	40
Japan	6	2	4	
Australia	2	1	1	
Taiwan	1	0	1	
Israel	1	1	0	
Total	154	98	56	64%

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Corporate Venturing

by Patrick J. Davey

Introduction

To venture is to embark on a project fraught with peril. In this broad sense, virtually all company undertakings are venturesome; but some clearly entail more than ordinary business risk. It is those involving extraordinary risk that constitute corporate venturing. Many major companies pursue venture strategies, despite historically high failure rates and long waits for returns from successful projects. What do they hope to accomplish? How successful are their efforts? The purpose of this report is to answer these and related questions by exploring the experience of corporate venturers, as well as the attitude of companies that have shunned or abandoned venturing.

Corporate venturing takes many forms: vigorous pursuit of internal R&D, cooperative R&D efforts, new product development programs, licensing, acquisitions, and investments in emerging businesses. This report focuses on corporate sponsorship of small companies; it also examines corporate experience with internal new business programs and other venturing vehicles.

The emergence of U.S. corporations as venturers in this sense is fairly recent. Prior to the end of World War II, much venture capital represented commitments by wealthy families in support of entrepreneurs whose proposals appealed to them. In the 1950's and 1960's public and private venture capital organizations, including Small Business Investment Companies (SBICs)² and corporations, began to appear in increasing numbers as suppliers of venture capital. The U.S. venture capital industry today encompasses private partnerships, investment banking affiliates, SBICs, financial institutions, such as banks and insurance companies, and industrial corporations. A some-

Major Findings

Corporations venture primarily to secure *attractive returns*, access to *technological developments*, *growth and diversification*, and improvements in *employee morale*. For the most part, they are reasonably satisfied with the results of their efforts; but some have experienced disappointment. Study participants that abstain from venturing indicate that it conflicts with strategic plans, offers insufficient financial inducement, or poses legal problems.

Believing that flexibility is essential to success, the companies surveyed typically use two or more venture investment approaches. Some set up internal groups to develop, invest in, and manage new businesses that have special growth appeal. Others take minority equity positions in small companies that have developed advanced technologies or hold other attractions. Still others participate in strategic alliances and spin-offs. And a number invest in independent venture capital partnerships, directly or through their pension funds.

Companies that prefer passive roles turn to external managers, ordinarily partners of independent funds, to oversee their venture investments. Other sponsors, especially those wanting to maintain very close relationships with the companies in which they invest, manage venture programs themselves. Some use external managers initially but switch to in-house administration later on.

Corporate venture managers often enjoy prestigious positions in the corporate hierarchy. They frequently report to senior officers and even, in a few instances, directly to the board of directors. A minority of study participants provide special incentive compensation programs for internal managers.

²See, for discussion of some of these approaches, James K. Brown and Lita M. Elvers (eds.), *Research & Development: Key Issues for Management*. The Conference Board, 1983, Report No. 842; Allen R. Janger, *Organization of International Joint Ventures*. The Conference Board, 1980, Report No. 787; James K. Brown and Lillian W. Kay (eds.), *Corporate R&D Strategy, Innovation and Funding Issues*. The Conference Board, 1985, Report No. 863; James K. Brown, *Refocusing the Company's Business*. The Conference Board, 1985, Report No. 873; James K. Brown and Lillian W. Kay (eds.), *Tough Challenges for R&D Management*. The Conference Board, 1987, Report No. 895.

³Small Business Investment Companies (SBICs) are licensed by the Small Business Administration of the federal government. They are an important source of financing for small businesses. For an explanation of the role of SBICs, see J. Fred Weston and Eugene F. Brigham, *Managerial Finance*. Hinsdale, Illinois: The Dryden Press, 7th Edition, 1981, pp. 993-995.

what more restricted community of venture investors, including a growing number of corporations, exists abroad, especially in Great Britain and the rest of Europe.

Domestic venture capital investments about tripled over the past several years and are now estimated to total \$22 billion.³ Perhaps one-fifth of that amount represents commitments of industrial corporations and financial institutions.

⁴Stanley E. Pratt and Jane K. Morris (eds.), *Guide to Venture Capital Sources* (Eleventh Edition). Wellesley Hills, Massachusetts, Venture Economics, 1987, p. 8.

Why Venture?

Companies venture either for strategic or financial reasons or for both. Often they desire to develop emerging businesses while realizing returns sufficient to compensate for the risks assumed. The objectives targeted by participating companies for their venture programs are presented in Table 2.

In several surveyed companies, venture goals were either changed entirely or underwent a switch in emphasis. For instance, some venturers reported that programs originally geared to developing scientific know-how are now aimed at realizing high rates of return. This demonstrates that, over time, they have come to regard their venture activities more as profit centers than as sources of technology.

Attractive Return on Investment

Studies reveal that the prospects for small emerging companies are limited. A 1982 study conducted among corporate sponsors, for example, found that 30 percent of all venture companies failed within two years of inception; another 30 percent suffered a similar fate thereafter. Only 40 percent of venture investments proved viable, of which three-quarters did reasonably well and one-quarter very well.⁴

Six venturers in the current survey report that they seek an average rate of return ranging from 15 percent to 70 percent; the median targeted return is 25 percent. Of course, to achieve such high returns, companies must establish much higher hurdles for individual undertakings to compensate for both unsuccessful investments and the lengthy period—five to ten years—typically required to liquidate or otherwise realize gains on profitable ventures. Explains the Executive Vice President of a U.S. financial institution's venture arm that requires a 25 percent rate of return for its entire portfolio: "Due to some companies becoming defunct, a minimum investment hurdle of 40 percent per year is required. For seed capital investing (prior to prototype development), the hurdle may be as high as 100 percent per year."

Window on Technology

The acquisition or transfer of technology is an important goal of many corporate venture programs. Through various kinds of cooperative arrangements, corporations hope to share in the benefits of the technological breakthroughs achieved by the entrepreneurial companies in which they have invested. (Noteworthy scientific accomplishments by small companies—as, for example, in the electronic and biotechnology industries—have contributed in significant ways to their sponsoring companies.) An official of a U.S. consumer products firm seeking technological support through venturing comments:

"Recently, we have made investments in two small computer technology companies. We believe each company is on the lead-

⁴Richard P. Greenthal and John A. Larson, "Venturing Into Venture Capital," *Business Horizons*, September-October, 1982.

Table 2: Venture Objectives in 98 Companies

Objective	Number of Mentions
Attractive return on investment	42
Window on technology	32
Growth and diversification	30
Enhancement of entrepreneurial spirit	13
Other	9
Total	126

ing edge of its area of expertise. Therefore, the purpose of these investments is to make sure that we stay abreast of their development work and provide a stable base of financing and management advice while their work continues. The investments were not, in other words, motivated by the prospect of financial gain, although we believe both companies will achieve a measure of financial success if properly supported.

"We are also considering an investment in the biotechnology area and a number of potential companies are under review. Here again, our motivation is to extend our research and development effort in areas of strategic interest and is not prompted by the desire for direct financial gain."

Growth and Diversification

Faced with poor or uncertain prospects in existing businesses, many companies turn to venture activities to enlarge their interests, and their goals are not always modest. One queried firm, maintaining that corporate renewal holds the key to survival, launched a new business development effort heavily dependent on venturing; it is targeted to add \$500 million to total corporate sales over a ten-year period.

The primary route to growth and diversification is acquisition, which venturing fosters. Venture investors often expand small initial investments in entrepreneurial companies to assume controlling interest—moves that enable venturers to achieve desired sales and restructuring objectives.

Enhancement of Entrepreneurial Spirit

"One of the major corporate initiatives is to foster and stimulate entrepreneurship in all phases of our business," says the Vice President, New Business of a U.S. company that has opted for venturing. Others, believing their firms are shackled by bureaucratic rules, view venturing as a means of instilling a more daring spirit in their organizations.

Other Goals

Marketing and training assistance are also cited as venture objectives. A utility company, for example, expects its commitment to venturing to contribute to the economic development of its service area and ultimately to its volume. A food company finds venturing a useful tool in management development. Its Director of Product Improvement states:

"We see venturing as an important and viable way of developing general managers or people for other key managerial positions. Working as leader of a venture gives individuals the

opportunity seldom available in other parts of the corporation to work with all aspects of a business. Additionally, we realize that many of our employees have excellent ideas that never surface under our existing structure. Helping them develop these ideas not only helps the corporation but also helps the individual develop in a self-fulfilling and meaningful way."

Venturing Is Not for Everyone

Fifty-six of the 154 surveyed companies do not sponsor emerging businesses at the present time; but ten of them—eight domestic and two foreign companies—are investigating the possibilities. Among the reasons respondents offer for not venturing:

- *It conflicts with the long-term plan.* "While we do continually evaluate merger and acquisition opportunities, the targets are generally proven firms in established industries. Investing in seed companies in emerging industries does not fit with our strategic plan," comments the Vice President and Controller of a U.S. transportation company.
- *It is not financially attractive.* Financial rewards from venturing, though attractive on a relative scale, may not appear substantial on an absolute basis, at least in the near-to-medium term, to companies whose earnings already amount to hundreds of millions or even billions of dollars.
- *It is not needed.* A few firms, pleased with their own internal R&D and new product development efforts, find it unnecessary to look to outside sources for growth. They prefer to rely on their own abilities.

Six of the fifty-six firms that currently do not sponsor corporate ventures are former venturers. The Director, Mergers and Acquisitions, of a participating U.S. chemical company, offers the following reasons for the changeover, echoed in whole or in part by others who have gone the same route:

"Executive management felt it was unlikely that a venture capital investment could have a significant impact on the bottom line of a company of our size;

"The general state of the venture capital industry was poor in the early and mid 1970's. On the other hand, there were significant demands for capital in the core business of the parent so it was difficult to compete for capital;

"Although the venture capital group was organized as a separate entity, the structure of its board and authorization policy resulted in the operating management of the parent corporation having a strong influence on the investment decisions;

"The preponderance of opportunities available for venturing were in electronics, telecommunications, software development, and medical device development. These areas did not fit our stated corporate strategy and therefore limited the chances of our finding a 'window on technology' related to our strategy; and

"Our experience showed that a corporate venturer was more vulnerable to legal action by other shareholders due to the 'deep pockets' view of a corporate venturer vs. a more conventional venture fund."

Table 3: Sources of Ideas for Venture Capital Projects

Source	Number of Mentions by U.S. Firms	Number of Mentions by All Other Firms	Total
Internal functions	32	11	43
External organizations	23	2	25
Outside professionals	6	-	6
Other	14	6	20
Total	75	19	94

Total number of firms answering this question: 45

Preparing for Venturing

After studying the pros and cons, companies that decide to pursue venture capital investments launch preparatory efforts. Initially, these focus on the generation of project ideas and the establishment of investment guidelines.

Generation of Investment Proposals

A steady stream of investment ideas is essential to the success of corporate venture programs, especially since relatively few are usually able to withstand the winnowing process. Table 3 indicates the sources from which 45 companies obtain recommendations on venture capital projects. What respondents stress, however, is that venture ideas can and do originate virtually anywhere.

Surveyed companies put suggestions from R&D and planning at the top of the list; marketing, development, manufacturing, financial and legal functions are cited as well. "Venture ideas nearly always originate in the groups and staffs as they seek to meet their objectives; however, input from management, corporate planning, treasury, legal, etc., is regularly obtained," notes a Senior Vice President of a U.S. manufacturing company. The branch networks of participating banks are also fertile ground, as the Managing Director of a British bank subsidiary notes: "The main source of introductions is the . . . branch network in the UK. Other sources are firms of professional advisers and other financial institutions such as syndicate partners."

Three study participants maintain task forces to identify possible venture situations. "Venture ideas can and do originate from all conceivable internal and external sources. The majority, however, are identified by a new venture group whose primary function is to do just that. The one source we have found to be uniquely infertile as a source of new business ideas is the venture capital community," comments the Chief Financial Officer of a U.S. manufacturing company.

Of course, this approach is not shared by all, and the venture capital community is often cited by other firms as an external source of venture ideas. As the President of a U.S. venture subsidiary remarks, "Our investment opportunities are generated through relationships with other venture capital groups, as well as lawyers and other professionals who represent entrepreneurs putting together start-up ventures . . . We have also developed relationships with a number of leading scien-

Sample Investment Guidelines

"Venture investments are made on the basis of a potential long-term strategic fit, a fit with existing capabilities and experience, the potential for significant revenue and earnings, and the potential for superior financial returns. To minimize charter overlap and to maximize autonomy, internal ventures also must serve a market segment not currently served by an existing organization and cannot rely on corporate marketing or manufacturing resources for their success; in turn, a venture's success cannot be key to corporate strategy. In addition, internal ventures must meet venture capital-like hurdle rates and are limited to a small up-front investment."

Diversified U.S. manufacturing company

"Our basic guidelines concern investment in situations where (i) proprietary technology or ideas exist; (ii) there is a basis for developing an enterprise that will have annual revenues of \$30-\$50 million in three to five years; and (iii) we expect a rate of return in excess of 40 percent compounded per annum."

Venture subsidiary, international mining company

"The subsidiary seeks companies with a solid understanding of their business and their markets. Proprietary product advantage and commercial promise are key factors, but management quality is the overriding consideration. We firmly believe that the eventual success of any start-up company is the direct result of management expertise, commitment, resourcefulness and tenacity.

"Our paramount concern is to meet the financial and strategic objectives of our investors. Investing in companies likely to achieve a successful start-up best meets those concerns. The subsidiary adds value to the portfolio companies by fostering a climate wherein company management and interested investors can rationally assess the likelihood of successful business alliances of benefit to all parties.

"We are interested in such fields as semiconductor fabrication support systems, electronic testing equipment,

telecommunications, defense electronics, data communications, bioengineering/medical diagnostics, health care products and services, specialty semiconductors, graphics, fiber and electro-optics, artificial intelligence, computer aided engineering, technical data processing, advanced materials, specialty chemicals, etc.

"We support every investment decision with extensive field research, drawing upon experience available with the parent as well as that of independent consultants. And we share with other investors our analysis of the company, its technologies and markets, when appropriate. The subsidiary seeks investments primarily in the start-up and early stage of new enterprise development, including seed financing, in which we work with entrepreneurs to develop business plans. We also consider appropriate mezzanine financings and management buyouts. Our investments range in size from \$500,000 to \$1.5 million and generally include a commitment to provide follow-on financing. Our investments involve a meaningful minority equity position for the subsidiary, although in selected situations we also consider debt or convertible debt instruments.

"We are prepared to be the lead investor or to co-invest with other committed venture capitalists. We work with a group of highly successful venture capital firms and investment bankers on both the East and West Coasts, as well as in Japan, Hong Kong, Singapore and Europe.

"During their four- to eight-year development time frame, we anticipate that most of our portfolio companies will go public or will merge with other companies, including possible alliances or mergers with some of our limited partners. At all times, we encourage management to pursue a business strategy that is most beneficial to the company and lend our support accordingly.

"We contribute to the venture company's success by pledging our full range of business and technical expertise and resources and, when suitable, by serving on the company's board of directors."

Venture capital subsidiary, U.S. manufacturing company

tists who put us in touch with new investment opportunities that they become aware of."

Bankers, accountants, lawyers, consultants, and, of course, entrepreneurs were among the professionals reported by companies as outside sources of venture ideas. Other sources include university research programs, trade shows, and conferences.

Investment Guidelines

The ground rules for investment in venture capital projects established by participating companies range from broad to specific and may or may not include financial considerations. For example, a guideline might target technological advances or define the stages of a proposed investment (see box). Or, it might spell out detailed instructions for:

- **Desired Returns.** Investors may set average annual return

objectives of 25 percent or more for funds placed in venture capital projects.

- **Constraints.** Some companies limit investment options. For example, companies may exclude investments in the manufacture of non-related products or in industries they consider subject to onerous regulation.

- **Location.** Venture sponsors sometimes restrict investments to a specific geographic area—often convenient to headquarters. Proximity is believed to facilitate monitoring in such cases.

- **Investment Preferences.** Preferred investment characteristics are often outlined.

- **Fields.** Genetic engineering or ceramics, for example, may be singled out as appropriate choices.

- **Size.** The amount of the investment may also be restricted. For instance, a company may set \$500 thousand as a minimum and \$5 million as a maximum commitment to any single venture. Type of financing is another investment feature regularly

A Contingent Investment Approach

One recently organized venture subsidiary of a U.S. manufacturing company has a three-part investment strategy. The firm initiated Stage I by investing a moderate portion of its available capital in several independent venture capital funds. This strategy is designed to provide access to attractive deals and technologies. Stage II calls for co-investing in independent partnerships to strengthen equity positions in certain preferred portfolio companies and to appraise the deals and the entrepreneurial enterprises. Stage III depends upon the success of the first two. If all goes well, the subsidiary will ultimately invest the profits realized from its earlier efforts directly in venture projects to achieve technological and financial advantages.

addressed. Sponsors may decide whether funds should be placed in early rather than later stages (see box).

- **Business Plans.** Of course, would-be investors in venture projects insist on reviewing business plans before furnishing financial or other support. The plans are expected to include: a history of progress to date, background information on management, and recent financial statements, as well as financial projections (e.g., balance sheets, profit and loss statements), product descriptions and marketing plans.

- **Other Policies.** The form and extent of holdings and of participation of officers or other company employees in venture organizations may be spelled out. For example, a sponsor may limit the percent of equity interest held in any venture and insist on board representation.

Ground rules are designed to fit the needs of individual companies and so vary considerably from one to another. See box for some representative investment guidelines.

Selecting Venture Capital Vehicles

After deciding to embark on a corporate venture, arranging for the submission of investment proposals, and setting out

Types of Venture Financing

Broadly speaking there are four types of venture financing: early stage, expansion, rescue, and mezzanine. Early-stage financing includes seed financing used by entrepreneurs to develop business concepts and prepare business plans; start-up financing for product development; and first-stage financing to begin manufacturing.

Expansion financing, as the name implies, is used for building the business and may involve two or more stages. Funds invested at each of these stages provide the capital necessary to sustain increasing levels of business activity.

Rescue financing is sometimes furnished in attempts to reverse the fortunes of ailing firms. Such funds are advanced to support the efforts of management, often of new management.

Funds also serve as mezzanine financing for companies on the verge of making public offerings. (On occasion, venture investors even purchase interests in secondary markets or participate in leveraged buy-outs.)

Table 4: Venture Vehicles Employed by Participating Companies

Strategy	Number of Mentions by U.S. Firms	Number of Mentions by All Other Firms	Total
Proprietary corporate venturing programs	57	21	78
Venture capital partnership investments	29	19	48
Pension fund venture investments	14	-	14
Joint ventures and strategic alliances	14	10	24
Spin-offs	2	2	4
Other	9	2	11
Total	125	54	179

ground rules to guide their programs, companies must then choose from among a variety of investment vehicles.³ Table 4 demonstrates that many of the 98 surveyed venturers opted for multiple approaches.

As a Vice President of a U.S. consumer products company succinctly comments, "Clearly, we believe that flexibility in venturing is crucial. There is no one defined route to success. Having multiple options is a benefit."

This sentiment was seconded by an Executive Vice President of a U.S. manufacturing firm: "We utilize all of the different approaches because each has advantages for specific circumstances. For example, investing through venture capital partnerships provides us with a broad overview of new markets and technologies, coupled with attractive financial returns. Direct investments enable us to work more closely with smaller companies where the fit (with the company in terms of technology, markets, etc.) is especially close, and where we can add value in ways beyond merely providing capital. Internal ventures can commercialize internally developed technology and provide the closest linkage between our venturing activities and our present operations."

Proprietary Corporate Venture Programs

Seventy-eight participating companies established internal units—subsidiaries, departments, divisions, intrapreneurial groups (entrepreneurs operating within large corporations), SBICs (in the case of U.S. banks)—to handle a portion or all of their venturing activities. Venture subsidiaries often function in a manner that parallels the activities of their external counterparts, venture capital partnerships; that is, they screen investment prospects, commit funds, monitor developments, and arrange the liquidation of investments. Other internal corporate venture groups may focus not only on direct investments in emerging firms but also on lending them managerial support. Or, through intrapreneurial efforts within the corporation, venture units may concentrate on the development of entirely new businesses.

³For a detailed perspective on venturing strategies, see Edward B. Roberts, "New Ventures for Corporate Growth," *Harvard Business Review*, July-August, 1980, pp. 134-142.

Venture sponsors see special advantages in many vehicles, but most agree that they attempt to select the vehicle best suited to their own purpose. Suitable vehicles generally serve diverse functions. For example, companies with proprietary programs believe this approach encourages the formation of close working arrangements with sponsored companies, permits better control over investments, fosters entrepreneurial spirit in their organizations, presents more opportunities for synergy, and contributes to the enhancement of "shareholder values."

Venture Capital Partnership Investments

Forty-eight of the respondents invest in venture capital partnerships, through which they become limited partners in venture funds managed by outsiders. Some externally managed funds are custom designed to meet the special requirements of corporate investors. A participating food company, for example, instructed its external manager to invest its funds solely in emerging food-related companies. The manager, in turn, created a special fund to meet that requirement.

Individuals with strong educational backgrounds in finance or science often manage private venture capital partnerships. They also usually possess considerable hands-on experience acquired through prior associations with investment banking firms, sizable family investment groups, or corporate venturing units. As managers, they apply their expertise to screening investment possibilities, examining the business plans of fund-seeking entrepreneurs, arranging investments, and disposing of investments at opportune times. They also work with emerging companies as board members, strategists, counselors and critics; partners may even choose new management when necessary.

For their efforts, venture capital partners receive management fees and a share in the proceeds at the time of liquidation. Managers often reap sizable rewards from successful funds, but few complaints are heard from other investors, who also benefit.

Firms that rely on venture capital partnerships believe they offer several advantages. First and foremost, they provide an introduction to an unfamiliar but alluring field of investment and permit companies to focus their investments in desired industries. Moreover, ties to independent partnerships frequently ensure that capable, well-motivated management will be in place from the outset to watch over the fortunes of the emerging companies.

Using venture capital funds to manage venture investments sharply cuts back the amount of time senior corporate managers must devote to this activity. The reports of independent partners also help corporate investors keep track of the flow of deals and of developments that can turn seemingly attractive projects into bottomless pits for investment funds.

Venturing Through Pension Fund Investments

Fairly recent developments encouraged 14 U.S. survey participants, some with little interest in other forms of corporate venturing, to commit a portion of their pension funds to venture capital investments. An early impetus came from the 1979

Department of Labor ruling that pension fund investments in venture capital projects did not violate the "prudent-man" standard. More current inducements include the attractive returns realized by many venture capital funds, the increasing use of pension fund venture investments by peers, and solicitations by venture capital partnerships. While the percentage of pension assets an individual firm devotes to venturing is usually small, the total amount invested is substantial, because of the large number and enormous quantity of pension funds.

Companies frequently choose independent partnerships as vehicles for their pension fund ventures. This route offers diversification, professional management, and, sometimes, above-average returns—features prized by pension fund money managers. On occasion, however, firms use pension funds to make direct investments in emerging companies.

Strategic Alliances

Strategic alliances suggest different arrangements to different participants. To some they are simply joint investments by two or more investors in a new company tailored to achieve a particular objective—as, for example, creation of a television production company by a broadcaster and a movie maker. Strategic alliances may also occur when companies pool their resources to secure a desired end. A retailer, for example, may attempt to increase sales volume and to raise profitability by affiliating with a company that provides financial services, such as insurance or banking. To others strategic alliances are special partnerships between mature and emerging companies, in which the established firm not only takes a minority equity position in the smaller one but also negotiates an agreement with it. (Agreements may include provisions for marketing or for R&D, for example.)

Whatever the form, strategic alliances are designed to benefit participants by combining their individual strengths in a fruitful union. Technological developments, competitive pressures, and cost considerations are among the key factors that prompted 14 domestic and 10 foreign respondents to enter into such alliances. Explains the General Manager of a European retailing company: "We have taken this approach (rather than external capital investing through venture capital funds) in the belief that there are opportunities for technology transfer between the investment and several of our businesses; we will have access to new project ideas and wider intellectual resources; and we can provide marketing and international distribution opportunities for the investment's potential new products."

Spin-offs

Internal R&D efforts sometimes result in the development of a promising product or technology that for one reason or another does not complement existing product lines. Confronted with that dilemma, four respondents reported separating or spinning off the new activity as a distinct and autonomous enterprise.

The sponsoring company can participate in any success recorded by the new business through licensing or other arrangements and through partial ownership. In this way spin-offs

facilitate divestment without complete loss of financial participation. Moreover, former employees of the parent company, anxious to test their mettle as entrepreneurs, usually assume management roles in the emerging enterprise.

An official of a venture capital subsidiary of a German manufacturer describes how a spin-off evolved: "In the middle of 1984, a team that had been working in the field of X-ray measurement technologies started its own business, fully supported by the parent. The former employees have established their own company to develop, manufacture and sell test equipment for integrated circuits. The head of the team had for years been developing the relevant technical concepts and patents.

"From this work there emerged not only the desired test instruments for the parent's requirements but also marketable products. These, however, did not fit in with the parent's large volume product range. Its sales departments are mainly geared to a standardized products business and not to the sale of this kind of special equipment. So the idea was born to set up an independent company which would deal with this kind of business.

"In return for the free use of the preliminary work done by the parent as well as the latter's patents, the entrepreneurs have granted their former employer a share option in their new enterprise. Following the foundation of the new enterprise, a German venture capital corporation has bought an interest in this firm."

The same German executive sees spin-offs as generally good corporate venture vehicles. In his view, they are an excellent means of developing entrepreneurial talents and of helping to overcome cultural norms that place higher value on job security than on "being one's own boss." The executive also cited another important by-product: the creation of employment opportunities.

Other Venture Forms

Other venture approaches occasionally mentioned by survey respondents include participation in university research programs and association with the scientific community. Contact with medical researchers prompted one company to organize and fund their work, which was considered promising. The company's ultimate objective was to acquire development rights.

Administering Ventures

Before launching venture programs, companies must decide to what extent they wish to be involved in administering their investments. Many prefer passive roles and turn to external managers, usually partners of independent funds, to handle their investments. Other firms choose to manage venture programs themselves, especially if they want to maintain a close relationship for strategic or financial reasons. Of course, some companies start out using external managers for their venture projects and gradually assume some or all of the management responsibility.

¹Carl Bewerunge, *Providing For Spin-Offs*. Transcript from a presentation at a Conference Board meeting: "Job Creation in Action: Methods That Work," Brussels, March 6-7, 1985.

External Administration

The partners of independent venture capital funds assume management responsibility for the monies entrusted to them by corporations and pension funds. These managers keep investors abreast of the performance of the various small companies in which funds are invested. Depending on the agreements worked out with corporate investors, other information of special interest may also be passed along.

Reliance on outside executives to administer venture investments does not completely eliminate the need for supervision, however. Often a committee or corporate executive from the investment, pension or development area serves as a liaison with fund partners and keeps senior corporate management advised.

Choosing Outside Funds

How do companies pick the venture capital funds in which they invest? Selection often hinges on the fund's track record, the personal accomplishments of fund managers and business philosophies.

While potential investors realize that a history of success is not necessarily an accurate barometer of a manager's performance, those with impressive score cards are ordinarily preferred. The educational achievements and work experience of the venture capital partners are also of interest to corporate investors. Strong academic and business credentials (especially in venture-related activities) are fairly standard requirements.

In addition, companies review the investment postures of venture capital partnerships. They are interested, for instance, in the industries in which investments are made, in how partners work with developing and investor companies, and whether assistance of various kinds from corporate investors is welcome. External venture capital managers whose business philosophy tends to parallel that of investors score critical points in the selection process.

Would-be venturers will also compare the fees charged by the partnerships under consideration. Some corporate investors even examine the schedule by which monies are paid in—entirely at the outset or in installments at different times or stages of development—for compatibility with their own plans.

Internal Administration

Companies that make direct investments in venture projects have little choice but to manage such commitments, but for many internal administration is more a matter of preference than of necessity. Table 5 points out the various approaches to internal management of ventures taken by respondents.

Forty-three, or three out of four, of the 58 respondents who gave details about their proprietary venturing programs have organized wholly owned subsidiaries or other special units to manage their venture investments. The territory of these organizations can and often does include the entire gamut of venture projects, from selecting and monitoring investments in independent venture capital partnerships to supervising relationships in strategic alliances and providing guidance to "intrapreneurs" (see box).

Table 5: Internal Administration of Ventures in Participating Companies

Administrator	Number of Mentions by U.S. Firms	Number of Mentions by All Other Firms	Total
Venture management subsidiary or other special units	33	10	43
Corporate group, division or department	6	6	12
Designated executive	3	-	3
Total	42	16	58

Total number of firms answering this question: 58.

For the most part, surveyed companies report that the management groups of their venture subsidiaries are fairly small. One subsidiary has a president, an executive vice president, three vice presidents, and a support staff; a second firm has four managers and a part-time secretary; while a third "consists of six professionals and is structured to function inter se as a partnership with three principals or partners (one of whom

Structuring for "Intrapreneurial" Efforts

Some companies, hoping to spur profitability by introducing new products or by entering untapped markets, believe internal venturing offers better prospects than acquisitions or other growth avenues. They encourage this through a variety of organizational approaches.^a For example:

- In one domestic manufacturing company, employees in R&D are encouraged to become intrapreneurs. They are given several operating options, ranging from fairly limited to virtually complete freedom. Regardless of the path chosen, intrapreneurs usually enjoy the support of senior R&D managers, and intrapreneurial groups are "sponsored, mentored, facilitated" by the parent's autonomous venture subsidiary.

- Another manufacturer forms venture teams with personnel drawn from a variety of existing corporate functions. These teams, usually of about five people, are launched without products to produce or markets to enter. Initially, they devote their efforts to brainstorming and to searching for growth opportunities. A corporate development committee devises a strategy, oversees funding, measures progress, and decides when an evolving venture is ready for commercial deployment in an operating unit.

- Several participants have established autonomous units to develop growth opportunities. These units contain or have access to the staff and functions—finance, marketing, engineering, for example—necessary to attain their goals. Units operate with little or no parental direction but are under the aegis of specially appointed boards or committees or of sponsoring operating divisions or groups.

^aFor detailed review of organizational approaches, see Michael G. Duerr, *The Commercial Development of New Products*. The Conference Board, 1986. Report No. 890.

acts as managing principal) with three associates." Officials of these venture subsidiaries often have legal, financial, technical or marketing backgrounds that assist them in their roles as venture capitalists.

The composition of special venture management units varies from company to company, but members often include representatives from several functions. For example, the venture management group of one domestic manufacturing company includes a corporate vice president, an individual from the corporate financial staff, and members of a small new business development group. Another management group consists of "all the business functions essential to its performance and success."

A manufacturer that utilizes a variety of venture forms organized a special unit to consider venture proposals that lacked support within the corporation. Explains its Director of New Opportunity Development: "Aside from the strategic thrusts of our existing operating groups and business units, their counterparts in the shared resources areas, and in R&D, the corporation has created a Venture Board, which is composed of senior management personnel, to review new business proposals that have difficulty achieving sponsorship elsewhere. The Venture Board reports at the corporate level and has an executive staff to manage the deal flow and to coordinate the corporate infrastructure necessary to facilitate the process."

In fifteen of the 58 participants, responsibility for venture management rests with existing company components or functions—groups, divisions, departments—or with individual executives. Although 20 of the 78 companies with proprietary venturing activities did not specify how they administered their programs, several report that they have no formal venture management organizations; rather, they rely on existing corporate entities to oversee those investments.

Reporting Relationships

Reporting relationships vary among surveyed companies. In those with venture subsidiaries or with special units devoted to venture activities, venture managers often report to the sponsoring firm's senior management or, in a few instances, directly to its board of directors. In declining order of survey mention, venture managers report to:

- Chief executive officers
- Vice chairmen
- Vice presidents of planning, development, R&D, finance
- Chairmen of executive committees

Where distinct venture management organizations do not exist, reporting levels are generally somewhat lower in the management hierarchy. For example, ranking above venture managers in the chain of command are vice presidents of development, functional managers, and vice presidents of groups or divisions.

Compensation Arrangements

While compensation of external fund managers is usually covered by agreements on management and profit-sharing fees,

that of internal administrators of venture projects depends on individual company practices. Special compensation arrangements for in-house venture managers exist in 14 responding firms, of which 13 have headquarters in the United States.

Incentive arrangements usually appear in venture subsidiaries and in other units that stress financial returns among their objectives. In an effort to motivate and retain internal managers, compensation packages are often tied to performance through profit-sharing agreements similar to those enjoyed by independent venture fund managers.

The special compensation plans of some contributors contain unusual twists that differentiate them from the basic percent-of-profit approach. An executive of a U.S. manufacturing company explains his firm's policy: "The venture management team does not receive special compensation—save that its incentive bonuses are tied into venture company objectives The general managers and key staff of operating companies within the venture company do receive special compensation. This includes annual incentives tied to milestones for their business; and an opportunity for major earn-outs at the end of a business plan period (three to five years). Additionally, intrapreneurs who successfully develop and commercialize a product receive a significant cash payment and a significant award of the parent's stock vested over three years."

Arrangements may include such features as stock options. In one company:

"Each venture company is initially 100 percent owned by the parent through an acquisition of 100 percent of the stock or through an initial cash infusion equal to an amount estimated to be needed to complete the development of the product.

"A special compensation package we have developed involves the issuance of stock options (primarily incentive stock options) in the individual companies which are exercisable in expiring increments over several years. The individual enters into a repurchase agreement with the company that allows the company to buy back the stock by the end of the eleventh year. The individual can sell the stock back earlier at his discretion and must sell it back if he leaves the parent or any of its subsidiaries. The repurchase price, since there is no public market, is determined by a formula developed to simulate the market price based on sales growth, profit and asset turns. This gives the individual the opportunity of financial reward if the company is successful."

Another firm ties rewards to venture milestones: "We have developed special compensation programs to reward new business groups for successful accomplishment of the business goals. These rewards recognize three phases of venture developments:

- *The idea phase* recognizes the inventor or originator of a new business concept.
- *The bundle and test market phase* recognizes the performance of the team in developing the product and marketing plans. The award is paid only after the product demonstrates its success in a live test market.
- *The commercialization phase* rewards key team members with a profit-sharing program as the new business begins to contribute positive earnings."

One manufacturing firm takes a more traditional approach:

"One area where we do not deviate from standard corporate procedure is in personnel matters. All venture subsidiary employees are corporate employees and get standard corporate benefits. The only exception is that the executive bonus, a standard corporate benefit for mid- and upper-level exempt employees, is tied to the performance of a specific start-up rather than to the performance of the company or collection of operations, as is typical for the rest of the corporation.

"In a couple of cases we have a payout formula for the participants, based specifically on performance of the venture, which is designed to minimize what might happen for a typical venture capital start-up at an initial public offering. The magnitude of such a one-time payment is limited both because of lower risks involved by the individuals and because of the need to keep a semblance of consistency throughout the organization. Despite the lack of extraordinary incentives, we have had no difficulty recruiting and motivating the staff of our start-ups."

Problems and Responses

Twenty-five respondents reported problems of varying severity in connection with their venture capital programs. The problems fall into three broad categories:

- Management difficulties
- Operational snags
- Conflicts of interest

Management Dilemmas

A few companies encountered difficulties with joint ventures or strategic alliances. Their experience demonstrates that friction over policy issues may arise when a partner changes objectives or fails to stick to an agreement. Unless such disputes are resolved, it is sometimes necessary for one or more participants to bow out. This is not the only alternative, however, as one executive explains: "When addressing problems in ventures, many times the first reaction is to get out of the venture and go it alone. Obviously, this is not always possible and, therefore, corrective actions are required. Probably the most often used solution is a change of people in the venture and, on the partners' side, in liaison personnel. Other corrective measures include reestablishing objectives and venture mission, establishing alternate levels of communication, refinancing, or looking for an additional or substitute partner(s)."

Some venture sponsors, particularly those that confine investments in emerging concerns to minority holdings, complain that sometimes their decision-making authority is too limited. This is especially painful when drastic action to protect an investment is needed. Increased investment, though often contrary to policy and lacking in appeal, may at least remedy or salvage the project.

Several of those queried experienced difficulty in administering new, intrapreneurial businesses. The challenge lies in guiding intrapreneurs without undermining their autonomy. Some venture sponsors attempt to overcome this problem by offering intrapreneurs considerable operating leeway, by negotiat-

ing mutually acceptable working relationships, by "jawboning," and by demonstrating a determination to make arrangements work.

A related problem for many firms is designing a compensation policy that is equitable for individual risk-takers as well as corporate sponsors. Often, this issue is resolved by devising compensation schemes that enable venturers to share in the profits of their endeavors.

Operational Difficulties

Several sponsors reported operational difficulties, such as getting all parties—subsidiaries, divisions, groups, entrepreneurs and managers—to work together in a way that would optimize results. Some firms choose to take whatever steps are necessary to promote cooperation and to improve communications among the various venture participants.

As the Executive Vice President of a domestic manufacturer put it: "The major challenge in structuring the venturing activity is to take fullest advantage of the technical and market strengths which exist within the corporation while achieving the 'broadening of horizons' for the corporation, which is an inherent goal. We have attempted to strike that balance by establishing a venture organization that is not directly attached to any single operating unit within the corporation but that has working relationships with each of them on an individual program or project basis. Thus the strengths of a given operating unit can be brought to bear in commercializing a specific opportunity, thereby maximizing the probability of success, while opportunities which are beyond the scope of a single operation, or which cross interdivisional boundaries, can be readily accommodated."

A few companies complained about the inordinate amount of senior executive and even board attention required when venturing is highly visible. They expect, however, that the "excess" time devoted to venture activities will diminish as top management gains experience. Should time remain a problem, reassessment is likely.

Other companies expressed concern about disappointing financial returns, which they are attempting to improve by employing more sophisticated management techniques and by being more cautious about investment choices.

Conflicts of Interest

Two respondents, both venture arms of U.S. financial institutions, voiced concerns about possible conflicts of interests arising from their venturing operations. Potential conflicts arise when the sponsor holds debt and its subsidiary holds equity in a venture organization that experiences financial difficulty. One respondent addressed the situation by refusing to "take a leadership role in the equity capitalization of a company where one of our affiliate banks is the lead lender;" in the other, "third parties were brought in to provide input."

Progress Appraisal

Participants take stock of the progress recorded by their venture investments at intervals that range from every quarter to

Table 6: Satisfaction with Accomplishment of Venture Objectives

<i>Level of Satisfaction with Results</i>	<i>Number of Mentions</i>		
	<i>U.S. Sponsors</i>	<i>All Other Sponsors</i>	<i>Total</i>
Pleased to date	21	7	28
Too early to make a judgment	9	4	13
Varies	6	-	6
Less than fully satisfied	2	2	4
Total	38	13	51

once yearly. For the most part, measurements compare financial performance and other variables with venture targets. As Table 6 indicates, the majority of survey respondents are satisfied with the results of their corporate ventures. However, many hedge assessments of their venturing objectives. This is in part because the final outcome, especially in financial terms, can only be determined upon liquidation or maturation of the investment.

The consensus is that patience is essential to the assessment of venturing achievements. However, as the General Manager of a British manufacturer's new-opportunities department makes clear, deciding whether to desist or to proceed with venture undertakings is anything but easy: "We know, and accept, that cumulative positive cash flow on major R&D product development can take a decade or more. It is, therefore, somewhat surprising that we tend to be more impatient about corporate venturing and have a tendency to 'pull the flower up by its roots' to see how it is going. There is no predetermined appraisal system, but an on-going look at our expenditures (particularly when trading results have been poor) often means that new businesses get reviewed more often than is really 'fair.' And we have hesitated to stay with some when—as happens more often than not, despite our best endeavors to produce realistic business plans—they need more money. We do usually find the money, even perhaps, when a decent burial might have been more appropriate. Learning when to stop, as in R&D, is something we have to develop."

More than half of those expressing an opinion on the effectiveness of venture programs are satisfied thus far, and another quarter are withholding judgment until investments mature. But some measure of dissatisfaction exists among the remaining respondents. Six companies experienced mixed results: some goal has been accomplished (e.g., financial return), but another has not (e.g., technology transfer). It could also be that one form of venturing achieved the desired results while another failed. Four companies were less than fully satisfied with venturing results, and may refrain from returning to the arena soon. Observes the Director, Strategic Planning, of a domestic manufacturing company: "All in all, the general level of satisfaction with recent venture efforts is not high. The two most recent ventures are in serious financial difficulties, and the burden on management time is indeed excessive. From a planning viewpoint, there exists a need for future venturing, perhaps under a different structure, but the current experience has dimmed the outlook for at least the near future."

The Final Outcome

What finally happens to venture capital investments in emerging companies? Outcomes vary but largely depend on the extent to which the objectives set for the investment are met and on investor preference. One of the following results is likely:

- The emerging company flourishes and goes public or is sold to other interests. (Either course permits venture capital partnerships or other investors, including direct corporate investors, to recoup their investments with appreciation.)
- Corporations may acquire small firms in which they have made investments, work out special agreements with them, or simply maintain long-term investment positions. In the case of spin-offs, investments may be retained or eventually sold. Promising internal start-ups may grow and become major underlying components of sponsoring parents, or they may be divested.
- Strategic alliances may dissolve when they no longer offer mutual benefits or culminate in mergers.
- Pension fund venture capital holdings are sold in accordance with the investment guidelines of individual companies or managers.
- Investments in unsuccessful organizations, whether made by independent partnerships or directly by corporate sponsors, may be liquidated at distress prices or simply written off.

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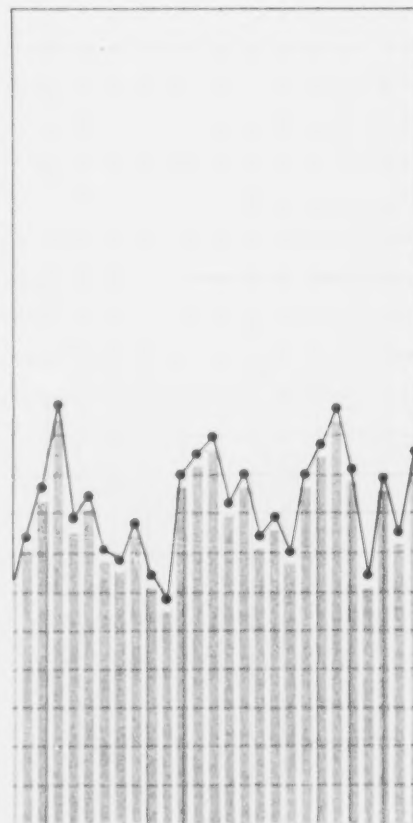
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